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Hunt, Katherine

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ARTICLES

THE LAW AND ECONOMICS OF MICROFINANCE

Katherine Hunt



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ARTICLES

THE LAW AND ECONOMICS OF MICROFINANCE

*Katherine Hunt**

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* Lecturer in the department of Accounting, Finance and Economics at Griffith University (Australia); Erasmus Mundus Scholar of the European Doctorate in Law and Economics at Erasmus University of Rotterdam, University of Bologna, Hamburg University; B. Psychological Science; B. Commerce; B. Finance with Honours; University Medallist; Qualified Justice of the Peace; Authorised Financial Adviser (Australia).

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I. INTRODUCTION

Microfinance may be the poster-boy of international development, but the facts remain that 100 million borrowers are in poverty and most Microfinance Institutions (MFIs) are not financially self-sustainable.¹ This means that there are systemic faults, which do not allow the goals of microfinance to be consistently achieved. This paper considers the interaction between regulation and the goals of microfinance being achieved, with specific focus on financially self-sustainable MFIs. Previous research has not considered microfinance from a law and economics perspective. Regulation has the potential to directly affect the financial sustainability of MFIs,² through restricting or supporting their business operations regarding obtaining capital and product design.³ Given that financially self-sustainable MFIs have the potential to increase long-term access to financial services without reliance on donations,⁴ the influence of regulation in this sector is a critical area for study. Despite the importance of the topic, little research has discussed the way regulation creates incentives for MFIs and borrowers, affecting financial self-sustainability.⁵ Thus, a law and economics perspective, which considers just this, is an important perspective from which to consider how microfinance can achieve its long-term goals. This article is the first which considers such an important yet overlooked issue. In order to consider the law and economics

¹ Financial self-sustainability refers to the ability of MFIs to operate on an on-going basis and to expand through financing and operations on market based rates. This means that MFIs which rely on NGO or subsidised lending in order to operate or expand are not financially self-sustainable. See Mostafa M. Hasan et al., *Local Government Investment Outreach and Sustainability of Microfinance Institutions: A Case Study of B, Bangladesh*, 34 J. SOC., POL. & ECON. STUD. 348 (2009).

² See, e.g., United Nations, The World Bank, Measuring Financial Inclusion: The Global Findex Database, Policy Research Working Paper 6025, Asli Demirgüç-Kunt & Leora Klapper (Apr. 2012), available at <https://openknowledge.worldbank.org/handle/10986/6042>.

³ Lucy Hurst et al., *Global Microscope on the Microfinance Business Environment*, Economist Intelligence Unit (2013), available at www.eiu.com/microscope2013.

⁴ Niels Hermes & Robert Lensink, *The Empirics of Microfinance: What Do We Know?*, 117 THE ECON. J. F1, F8–F9 (2007) (authors find that the financial self-sustainability of MFIs is linked to long term benefits to the poor).

⁵ Most published research in the field of microfinance is anecdotal in nature and takes the perspective of “bottom-up” being the effect of microfinance on the poor, rather than a strategic perspective of how regulation affects MFIs.

of microfinance this article will present a comparison between financial relationship in developed and developing contexts and explore how microfinance completes a credit market failure that has resulted in those who are willing and able to obtain financial services being excluded from the market.

Despite microfinance being a popular topic for academic discussion, little of the previous research has been conducted in an empirically sound manner, and even fewer considering the financial management of MFIs.⁶ This paper presents a discussion previously untouched in the literature by focusing on the available literature, which is empirical in nature. Some of the reasons for the general lack of empirical research in this field are inherent to the sample and instruments.⁷ Hermes and Lensink discuss the methodological weaknesses of most microfinance papers in this field as being that the variables to measure behaviour are only theoretically and indirectly related; that crude one-dimensional measures are used to proxy for complex constructs; and the endogeneity of the sample.⁸ Hermes and Lensink consider the effect of these methodological weaknesses and the importance of financial sustainability of MFIs. In particular, these authors find that if MFIs are unable to stand on their own “financial” feet, long-term large-scale outreach to the poor cannot be guaranteed.⁹ Further, at a short-term level, these authors discuss how microfinance sustainability affects the breadth¹⁰ and depth¹¹ of the clients served.

Previous research on microfinance has covered a variety of literature that theoretically, anecdotally, or qualitatively considered the effect of microfinance on increasing the socioeconomic well being of the poor,¹²

⁶ Some exceptions to this are some papers published by The World Bank, and others that will be presented in the current paper.

⁷ Hermes & Lensink, *supra* note 4, at F3.

⁸ *Id.*

⁹ *Id.* at F8–F9.

¹⁰ This refers to the numbers of borrowers reached.

¹¹ This refers to the socioeconomic situation of borrowers reached. In the context of microfinance, it is important that the “poor” are reached, as they are ordinarily excluded from the formal financial system, and microfinance is an initiative designed to address this financial exclusion in developing countries.

¹² Moh’d Al-Azzam et al., *The Impact of Socioeconomic Factors and Financial Access on Microfinance Institutions*, 4 INT’L J. ECON. & FIN. 61, 67 (2012).

which is inherently a bottom-up perspective.¹³ Previous research has found that while the social goals of microfinance, in particular female empowerment, have been consistently reached,¹⁴ reductions in poverty have not been found relative to the economic goals of microfinance.¹⁵

Microfinance has confirmed social benefits and potential economic benefits through providing access to credit for the poor.¹⁶ Although the economic benefits of microfinance have not been empirically studied in an exhaustive number of studies, there is enough evidence to suggest that microfinance does not have a negative effect on economic development,¹⁷ does not cost society or the government excessive amounts of fund to support it,¹⁸ and thus, it may be an appropriate system for increasing credit availability of the poor.¹⁹ In light of this, the current paper seeks to understand what institutional conditions can promote microfinance. In order to do this, the current article presents theoretical analysis from the law and economics perspective and presents the findings of the few empirical articles on microfinance. These discussions will be framed by consideration of the goals²⁰ of microfinance considering the normal banking relationship.

In analysing the development of microfinance law, it is intuitive to begin at a consideration of regular financial relationships; why the poor are

¹³ Considering microfinance in terms of the effect of loans on the borrowers mental health, socioeconomic standing and well-being is “bottom-up.” This is in comparison to a “top-down” perspective, which considers strategic issues such as regulation and business operations.

¹⁴ Philip Megicks et al., *Enhancing Microfinance Outreach through Market-Oriented New Service Development in Indian Regional Rural Banks*, 23 INT’L J. BANK MARKETING 107 (2005).

¹⁵ For a summary of the research supporting and challenging the benefits of microfinance see Katherine Hunt, *Microfinance: Dreams and Reality*, 2 INT’L REV. ON TRANSITIONS IN CORP. LIFE, L. & GOVERNANCE 62, 77 (2013).

¹⁶ Christian Ahlin & Neville Jiang, *Can Micro-Credit Bring Development?*, 86 J. DEV. ECON. 1, 2 (2008); see also Gail Arch, *Microfinance and Development: Risk and Return from a Policy Outcome Perspective*, 6 J. BANKING REG. 227, 241 (2005).

¹⁷ See, e.g., Francisco J. Buera et al., *The Macroeconomics of Microfinance*, Working Paper No. 17905, NAT’L BUREAU OF ECON. RES. (Mar. 2012), available at <http://www.nber.org/papers/w17905>. These authors illustrate that when using General Equilibrium and Partial Equilibrium there are economic benefits of microfinance.

¹⁸ For governments to support microfinance it needs only regulatory support, rather than investment of funds. Hence, relative to other humanitarian initiatives, microfinance is not costly to support.

¹⁹ For work on credit access, see, e.g., Daniel Agyapong et al., *Criteria for Assessing Small and Medium Enterprises’ Borrowers in Ghana*, 4 INT’L BUS. RES. 132 (2011).

²⁰ Rafiqur Rahman & Qiang Nie, *The Synthesis of Grameen Bank Microfinance Approaches in Bangladesh*, 3 INT’L J. ECON. & FIN. 207 (2011).

excluded from traditional financial relationships,²¹ and why regulatory support may be needed to promote microfinance.²² It has been established that microfinance is a method to increase financial inclusion.²³ However, the poor have always had access to credit via family, friends,²⁴ and “loan sharks.”²⁵ These credit sources are not efficient: during economic or weather disasters, the regular sources of credit may no longer become available because the family or friends need the capital for their own survival.²⁶ Thus, microfinance provides an avenue for a source of credit that is potentially more reliable. This is even more likely if MFIs are able to operate in a financially self-sustainable manner.²⁷

This article presents a theoretical analysis regarding the law and economics of microfinance. The theoretical perspectives presented in the current article inherently scratch only the surface of the potential analyses on the financial and structural detail of microfinance and general financial relationships. The problem-oriented discussions presented in this article provide a framework for discussing microfinance relationships with the goal of providing a foundation from which future discussion and research can build. As the first article on the topic of the law and economics of microfinance, this is required.

Part II of this article considers normal banking relationships in a problem-oriented way, designed to provide background information from which subsequent discussions can build. This means that the current article will discuss the banking literature as far as it is relevant for microfinance and thus will remain at the surface of understanding and analysis regarding

²¹ Mohammad Shafi & Ali Hawi Medabesh, *Financial Inclusion in Developing Countries: Evidences from an Indian State*, 5 INT'L BUS. RES. 116 (2012).

²² See, e.g., M. Wakilur Rahman & Jianchao Luo, *The Development Perspective of Finance and Microfinance Sector in China: How Far Is Microfinance Regulations?*, 3 INT'L J. ECON. & FIN. 160 (2011).

²³ Shafi & Medabesh, *supra* note 21.

²⁴ The method, though, was expensive and unreliable. Robert Mayer, *Loan Sharks, Interest-Rate Caps, and Deregulation*, 69 WASH. & LEE L. REV. 807, 820 (2012).

²⁵ *Id.* Loan sharks make credit available to those in need with flexible loan and repayment terms. They do not always take collateral, however, as they are outside the financial system. Non-repayment often results in violence, slavery, or worse. Loan sharks are part of the TML system, which is a blanket term including also family and friends as traditional sources of capital.

²⁶ *Id.*

²⁷ Peter Crabb, *Economic Freedom and the Success of Microfinance Institutions*, 13 J. DEV. ENTREPRENEURSHIP 205, 217 (2008).

certain issues. Part III discusses access to finance being restricted from the poor. Part IV outlines the effectiveness and distributional goals of microfinance. Part V discusses facilitative regulation and CSR as potential initiatives. Part VI discusses direct regulation as a potential initiative to support microfinance; and the conclusion compares and contrasts Parts V and VI to determine the process of regulation most suited to promoting microfinance.

II. TRADITIONAL FINANCIAL RELATIONSHIPS

A. What Does a Normal Banking Relationship Look Like?

Financial relationships are an aspect of normal life that many in the developed world may take for granted, because in developing countries what is considered a normal financial relationship exists only for the middle and upper classes.²⁸ As a result of this heterogeneity in who has access to financial services, much of the ideas of “normal financial relationships” comes from developed countries.²⁹

Regardless of the location of the financial institutions or the characteristics of the client base, aspects of the financial relationship remain consistent.³⁰ This is because people all over the world require financial institutions for consistent reasons and products are tailored to provide for these. In particular, people go to financial institutions to manage their risk,³¹ build wealth,³² manage cash flow,³³ and transfer money.³⁴ These financial

²⁸ Shafi & Medabesh, *supra* note 21.

²⁹ A plethora of papers consider financial relationships in developed countries ranging from innovations in financial services to financial planning.

³⁰ Financial products have a consistency across companies as required by law in such regulations as: ASIC, Disclosure: Product Disclosure Statements.

³¹ Examples of this include insurance, fixed rate loans, and deposits. *See, e.g.*, Franklin Allen & Douglas Gale, *Innovations in Financial Services, Relationships, and Risk Sharing*, 45 MGMT. SCI. 1239 (1999); John Y. Campbell & João F. Cocco, *Household Risk Management and Optimal Mortgage Choice*, 118 Q. J. ECON. 1449 (2003).

³² Examples of this include interest bearing savings accounts, investment portfolios and home mortgages. *See, e.g.*, Asif Dowla & Alamgir Dewan, *From Microcredit to Microfinance: Evolution of Savings Products by MFIs in Bangladesh*, 15 J. INT'L DEV. 969 (2003).

³³ An example of this is a personal loans. *See, e.g.*, Victor Stango & Jonathan Zinman, *Exponential Growth Bias and Household Finance*, 64 J. FIN. 2807 (2009).

services are demand driven and products are designed within regulatory environments to suit the needs of customers. Thus, customers choose to have financial relationships because they have specific needs that financial institutions can meet. Normal financial relationships have consistent motivations and designs across the world.³⁵

The current research is primarily concerned with microfinance as a source of credit for the poor and other financial services tailored to the needs of the poor such as microsavings, microinsurance, and microbanking, like money transfer via mobile phones.³⁶

Traditional financial relationships include information asymmetry for both parties where the cost of information and search provides customers and banks with avenues to benefit from the relationship.³⁷ Information asymmetry is a generic problem in banking relationships and banking law is often designed to attempt to reduce these asymmetries because of the resulting market failure.³⁸ In traditional banking relationships, information asymmetry is reduced through signalling and monitoring.³⁹ That is, borrowers signal to the bank that they are worthy of loans through providing financial reports, business plans, and offering collateral.⁴⁰ The

³⁴ For example, money transfers to sellers or to family overseas. See Shahid Nawaz et al., *Informal and Formal Money Transfer Networks: Financial Service or Financial Crime?*, 5 J. MONEY LAUNDERING CONTROL 330 (2002).

³⁵ Allen & Gale, *supra* note 31.

³⁶ In terms of a general definition of microfinance, a useful paper is United Nations, The World Bank Thematic Group on Poverty Analysis, Monitoring and Impact Evaluation, *Impact Evaluation for Microfinance: Review of Methodological Issues*, Doing Impact Evaluation No. 7, Dean Karlan & Nate Goldberg (Nov. 2007), http://siteresources.worldbank.org/INTISPMA/Resources/383704-1146752240884/Doing_ie_series_07.pdf.

³⁷ For a basic discussion of information asymmetry in general, see, e.g., George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961).

³⁸ For a discussion of how asymmetric information can lead to banks building a monopoly because of the fact that they decrease their information asymmetries as the lending relationship progresses, see, e.g., Steven A. Sharpe, *Asymmetric Information, Bank Lending and Implicit Contracts: A Stylized Model of Customer Relationships*, 45 J. FIN. 1069 (1990) (monopolies in otherwise free markets are generally considered market failures).

³⁹ The mortgage literature generally considers that the fact-gathering procedures before loans are granted are designed to reduce information asymmetry on behalf of the bank. Further, the information gathered through the repayment behaviours of borrowers via on-going monitoring further serves to decrease asymmetric information to an even greater extent, as discussed in footnote 37.

⁴⁰ For a discussion on collateral, see Arito Ono & Ichiro Uesugi, *Role of Collateral and Personal Guarantees in Relationship Lending: Evidence from Japan's SME Loan Market*, 41 J. MONEY, CREDIT & BANKING 935, 940 (2009).

bank then monitors the borrower.⁴¹ In terms of banking relationships for the poor, the problems of information asymmetry are magnified because the poor are without methods to signal loan worthiness: they are unlikely to have collateral or financial statements.⁴² Small loan sizes mean banks are faced with high proportional monitoring costs per loan,⁴³ so they expect a signal of quality but the poor do not have collateral⁴⁴ to give. The result of this is the poor are left without access to capital.⁴⁵ Hence, MFIs have been created which are designed based on a model where the poor are able to provide intangible collateral.⁴⁶ This is a key innovation of microfinance from an economics perspective—the ability to substitute tangible with intangible collateral.⁴⁷

In the microfinance sector, the demographics of borrowers make issues around information asymmetry particularly relevant.⁴⁸ However, the community selection and endorsement of borrowers minimises the information asymmetries and subsequent possibilities for the adverse selection of borrowers.⁴⁹ Although traditional banking relationships do not use community selection or social pressure in the models of repayment, this

⁴¹ *Id.*

⁴² Tadeo A. Satta, *Microfinance Regulation Influence on Small Firms' Financing in Tanzania*, 12 J. FIN. REG. & COMPLIANCE 1358 (2004) (suggesting the poor generally don't have access to collateral).

⁴³ Nirvikar Singh, *Transaction Costs, Information Technology and Development*, 1 INDIAN GROWTH & DEV. REV. 1, 21 (2008) (considering the operational costs of MFIs in illustrating their challenges in providing long-term financial inclusion).

⁴⁴ I.e. the signal.

⁴⁵ Shafi & Medabesh, *supra* note 21.

⁴⁶ I.e. social pressure.

⁴⁷ See, e.g., Isidore Ekpe et al., *The Effect of Microfinance Factors on Women Entrepreneurs' Performance in Nigeria: A Conceptual Framework*, 1 INT'L J. BUS. & SOC. SCI. 255, 257 (2010); Ono & Uesugi, *supra* note 40; Johannes Stroebel, *The Impact of Asymmetric Information about Collateral Values in Mortgage Lending* (2012) (unpublished manuscript) (on file with the New York University Stern School of Business).

⁴⁸ James C. Brau & Gary M. Woller, *Microfinance: A Comprehensive Review of the Existing Literature*, 9 J. ENTREPRENEURIAL FIN. & BUS. VENTURES 1, 22–23 (2004) (clients are generally rurally dispersed and illiterate).

⁴⁹ Microfinance repayment rates are theoretically based on the community endorsement that is required before a loan is granted. Although a non-related member of the community must vouch for the borrower's willingness and ability to repay, the endorsing person is not liable if the borrower defaults. However, in collectivist cultures the strength of social ties are usually enough to ensure repayment. See, e.g., Christian Ahlin & Robert Townsend, *Using Repayment Data to Test Across Models of Joint Liability Lending*, 117 ECON. J. F11 (2007).

contractual technique in microfinance has contributed to repayment rates of 99%.⁵⁰

B. Financial Market Players and Their Incentives

Borrower incentives for on time loan repayment are partially affected by the level of recourse available to banks, which is reinforced by banking regulation.⁵¹ In addition to incentives for loan repayments, there are also contractual methods to ensure on time regular payments such as late fees and permanent credit history (or credit score) records.⁵² Borrowers with full recourse contracts have incentives to repay the loan whereas those without only have the loan repayment incentives if capital values increase.

Lenders operate in different environments depending on the legislation of the country, and the subsequent nature of the competition they face.⁵³ The strength of the competition has the potential to influence the products that are developed, the level of relationships sought with and by borrowers, and the marketing strategies employed to obtain new customers and maintain existing ones.⁵⁴ Thus there are diverse incentives on lenders in operating and managing customer relationships, affected by regulation.

Bank financing has been constantly changing over the past few decades, with an increased use of securitisation and lower reliance on deposits.⁵⁵ However, authors have found that there is a relationship between

⁵⁰ This author analysed the data available for microfinance repayments, among other things, between the period of 1996–2009 and found a write-off ratio for loans at 1% of loans. That means that repayment was 99%. This author used the widely available Microfinance Information Exchange data for that period. For methodological detail, refer to the paper itself. Gabriel Di Bella, *The Impact of the Global Financial Crisis on Microfinance and Policy Implications* (Int'l Monetary Fund, Working Paper No. 11/175, 2011).

⁵¹ See, e.g., Mike Berry, Tony Dalton & Anitra Nelson, *Mortgage Default in Australia: Nature, Causes and Social and Economic Impacts* (Austl. Hous. & Urban Research Inst., Final Report No. 145, 2010).

⁵² Confidence W. Amadi, *An Examination of the Adverse Effects of Consumer Loans*, 7 INT'L J. BUS. MGMT. 22 (2011).

⁵³ Thorsten Beck et al., *Is Small Beautiful? Financial Structure, Size and Access to Finance* (The World Bank Dev. Research Grp., Pol'y Research Working Paper No. 5806, 2011).

⁵⁴ See, e.g., Abbad Muneer et al., *Limitations of E-Commerce in Developing Countries: Jordan Case*, 4 ED. BUS. & SOC'Y: CONTEMPORARY MIDDLE EASTERN ISSUES 280 (2011).

⁵⁵ See, e.g., Farhad Hossain & Tonya Knight, *Can Micro-Credit Improve the Livelihoods of the Poor and Disadvantaged? Empirical Observations from Bangladesh*, 30.2 INT'L DEV. PLAN. REV. 155 (2008).

the cost of capital and internal financial resources if there are external financing constraints,⁵⁶ and that this can also affect real economic activity through the provision of finance via business and personal channels. The trend away from reliance on deposits and towards financial leverage⁵⁷ has a variety of advantages and disadvantages particularly relevant for MFIs and is discussed in Parts following. Authors have commented on the factors which banks are interested in within the lending relationship. Namely, Stiglitz and Weiss⁵⁸ detailed how the contract effectively induces the borrower to act in the best interest of the bank.

1. Access to Credit and Bank Size

The effect of the size of financial firms on financial access is an important topic which is relevant for determining the impact of factors related to microfinance and microfinance institutions within the context of the financial sector. A recent study by Demirgüç-Kunt, and Singer⁵⁹ examined how a higher number of large banks would influence credit availability of different sized firms. This study has strong theoretical and empirical importance because of potential assumptions by policy makers that bank size and strength increase credit access.⁶⁰ On a more practical level, these authors noted that access to financial services by Small and Medium-sized Enterprises (SMEs) is critical in developing countries because SME's comprise most of the private sector.⁶¹ This study found that the average size of banks is not associated with access to finance.⁶² This is contrary to traditional banking regulatory motivations which aim to

⁵⁶ See, e.g., John L. Campbell et al., *Financing Constraints and the Cost of Capital: Evidence from the Funding of Corporate Pension Plans*, 25 REV. FIN. STUD. 868 (2011).

⁵⁷ Given that MFIs are not always able to receive deposits because of regulatory restrictions, alternative methods such as seeking capital on the capital markets has been pursued more and more in recent years. This allows MFIs to fund their expansion and ongoing costs. This trend has been discussed by: Arch, *supra* note 16; James Cerven & S.M. Ghazanfar, *Third World Microfinance: Challenges of Growth and Possibilities for Adaptation*, 24 J. SOC., POL. & ECON. STUD. 445 (1999).

⁵⁸ Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393 (1981).

⁵⁹ Beck et al., *supra* note 53.

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

promote bank strength and dominance.⁶³ Specifically, these authors found that financial markets in developing countries with more large banks resulted in reduced financial service use by firms of all sizes.⁶⁴ They found that it is specialised lenders⁶⁵ which increased firms' access to finance. However, they also found that microfinance does not help with the financing constraints of formal and larger enterprises, which is logical given the target market of microfinance and the products designed to service them. Beck et al.⁶⁶ commented in describing the implications of their results that policy makers control financial institution size and thus specific financial market structure by determining regulations which impose entry barriers, minimum capitalisation requirements and bank ownership restrictions.

2. Wealth Creation

The theoretical strength of microfinance lies in its ability to increase wealth through the mobilisation of capital for entrepreneurial and investment opportunities by the poor.⁶⁷ This individual wealth creation aspect is critical for the potential benefits of microfinance because it runs hand in hand with increases in economic development.⁶⁸ Bauer, Chytilová, and Morduch⁶⁹ empirically analysed why microfinance has such financial benefits over programs such as those which focus on savings. These authors thus examine microfinance as an innovation for self-discipline of financial

⁶³ Australian Treasury, *Release of the Report of the Financial System Inquiry and Initial Government Response on Mergers Policy*, Financial System Inquiry (Apr. 9, 1997), <http://fsi.treasury.gov.au/content/PublicInformation/Pressreleases/PR090497.asp>.

⁶⁴ Beck et al., *supra* note 53.

⁶⁵ Such as MFIs.

⁶⁶ Beck et al., *supra* note 53.

⁶⁷ In terms of a general definition of microfinance a useful paper is Karlan and Goldberg, *supra* note 36.

⁶⁸ This is based on the importance of the poor "lifting themselves out of poverty" rather than having poverty eradication methods imposed upon them, which intuitively indicates a more sustainable anti-poverty strategy.

⁶⁹ See, e.g., Michal Bauer et al., *Behavioral Foundations of Microcredit: Experimental and Survey Evidence from Rural India*, 102 AM. ECON. REV. 1118 (2012).

behaviour,⁷⁰ and the results have been published in the *American Economic Review*.

The results of the study by Bauer et al. show that self-discipline is the reason why people cannot save but can repay loans in rural India.⁷¹ Specifically, women who are more present biased⁷² are more likely to borrow from an MFI. This is because they have more need to borrow than non-present biased women because of a greater tendency to spend income.⁷³ It can be logically extended that microfinance is more efficient than saving because of social pressure and a regular repayment structure which provide greater incentives for financial discipline than regular savings programs.⁷⁴ Other authors have also commented on this hyperbolic discounting aspect of microfinance.⁷⁵ Contrary to many statistics, Bauer et al. found that most borrowing is used for investment.⁷⁶ These results also provide support for the rigid and regular repayment schedules, which other studies⁷⁷ have

⁷⁰ *Id.* These authors used a behavioural economics perspective. In order to determine the reason for the repayment success of microfinance, Bauer et al. used a random walk method to select nine villages per *taluk* and 35 people per village in rural India. The researchers had a high response rate with 90% participation acceptance. The sample of respondents was generally representative of the population except that there was marginally lower literacy and higher marriage than the region average. This study determined the discount rate by asking respondents if they would prefer “Rs250” tomorrow or Rs265/280/300/330/375 in three months’ time. They also identified time preference reversals. The methodological procedure of this study seems sound in that the same subjective transaction costs apply to both options available to the subjects because all payments are in the future. Subjective transaction costs refer to perceived higher transaction costs of future payments and the effect that hyperbolic discounting has on the desire to consume sooner rather than later. Further, risk tolerance was determined by a simple gambling game. The data which was collected related to demographics, wealth, and women’s position in the household.

⁷¹ *Id.*

⁷² *Id.* Present bias refers to the preference to consume today rather than later. This is also referred to as hyperbolic discounting. These authors categorise present-bias as when the calculated personal current discount rates are larger than future discount rates, and is generally one third of the population. In a practical sense, this means that these people are impatient about consumption choices for tomorrow but not for consumption choices in one year’s time. This study further distinguishes between “weakly” and “strongly” present-biased participants.

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ This is where future events are discounted at higher rates than in the near future. *See, e.g.*, Richard Herd et al., *Financial Sector Reform in India: Time for a Second Wave?* (Org. for Econ. Co-operation and Dev., Economics Department Working Papers No. 879, 2011).

⁷⁶ *Id.* The results hold after controlling for time-discounting and the propensity to borrow.

⁷⁷ *See, e.g.*, Sarah Pearlman, *Flexibility Matters: Do More Rigid Loan Contracts Reduce Demand for Microfinance?* (Vassar Coll. Dept. of Econ., Working Paper, 2010).

indicated may reduce the uptake of microfinance. Further, these results explain why despite a move towards individual contracts, the regular repayment schedules and regular group meetings model has been maintained.⁷⁸ The results of the empirical study by Bauer et al. show that many of the issues which affect the wealth creation of individuals in developed countries also affect microfinance borrowers.

C. Contracts

I. Contracts and Risk Management

The law regarding the enforcement of contracts is a result of the information asymmetries between contract parties and ensures that property rights are upheld.⁷⁹ Without a mechanism to enforce contracts and in a low trust environment, it is possible for the financial system to be very inefficient.⁸⁰ A financial system functioning in developed countries is built on a foundation of trust and enforced property rights legislation.⁸¹ However, the microfinance sectors in developing countries usually do not have this foundation,⁸² and the result of this may be less pronounced economic effects of microfinance.⁸³ Contract enforcement in developed countries thus relies on a combination of cultural norms and institutional support. This is in contrast to microfinance contracts whose enforcement is instead supported by social pressure from other community members.⁸⁴

Contracts are designed to ensure both parties have reduced risk despite the inherent information asymmetries present in all financial relationships.⁸⁵ In this way, contracts are essentially a risk management tool. This is

⁷⁸ This is because, as illustrated by Bauer et al., *supra* note 69, it is the discipline which results in financial improvements in personal financial situation rather than simply the ability to save.

⁷⁹ See, e.g., K.M. Waziri, *Industrial Property Rights Protection and Entrepreneurship Development in Nigeria: The Economic Implication*, 5 J. POL. & L. 93 (2012).

⁸⁰ This is often the case in developing countries where microfinance is present. See, e.g., Stefanos Mouzas et al., *Trust and Reliance in Business Relationships*, 41 EUR. J. MARKETING 1016 (2007); Nawaz et al., *supra* note 34.

⁸¹ Waziri, *supra* note 79.

⁸² Nawaz et al., *supra* note 34. This was also discussed in *supra*, Part II.A.

⁸³ Brau & Woller, *supra* note 48.

⁸⁴ Jorge Luis Rodríguez-Meza, *Group and Individual Microcredit Contracts: A Dynamic Numerical Analysis* (2000) (unpublished Ph.D. dissertation, Ohio State University) (on file with author).

⁸⁵ See *supra* Part II.A.1 where this is covered in depth.

because it is not that risk should be avoided, but simply that uncertainty is something people will pay to circumvent because it is unquantifiable, unlike risk.⁸⁶

2. Risk Based Interest Rates

In traditional banking relationships borrowers pay interest rates as a way to provide an incentive to the bank to give up capital which they otherwise could have used.⁸⁷ The interest rates charged depends on the level of cost associated with providing the loan and the risk associated with doing so.⁸⁸ The consideration of a traditional financial relationship allows that the role of microfinance can be better understood, as interest rates are also charged relative to the cost of providing the loan.⁸⁹

The risk management practices outlined above ensure that the pricing of risk into financial products is easily reflected in the interest rates charged.⁹⁰ That is, large balance loans are linked with collateral and charged low interest rates.⁹¹ In contrast, low balance unsecured loans are charged high interest rates reflective of the higher proportional transaction costs, the risk of delayed repayment, higher recovery costs in the event of default, and consideration of the smaller loan balance.⁹²

D. Credit Market Failure

The combination of lack of collateral, undocumented abilities to repay the loan, and associated factors of illiteracy and regional diversity means

⁸⁶ FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT (Houghton Mifflin Co. 1921). For a general discussion on uncertainty, see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

⁸⁷ See *supra* Part II.A.

⁸⁸ See, e.g., Dean Karlan & Jonathan Zinman, *Credit Elasticities in Less-Developed Economies: Implications for Microfinance*, 98 AM. ECON. REV. 1040 (2008).

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ The costs of providing the loan are not directly proportional to the loan size and thus easily covered by the interest on such a large principal. For a discussion of this issue, see Ono & Uesugi, *supra* note 40.

⁹² This is in contrast to high balance loans, which, even with lower interest rates charged, do recoup a higher proportion of fees relative to the loan balance. See, e.g., John Kose et al., *Credit Ratings, Collateral, and Loan Characteristics: Implications for Yield*, 76 J. BUS. 371 (2003).

that in the traditional financial sector, the poor do not have access to financial services.⁹³ There is a market failure because the poor are not being provided with credit, despite the fact that they are willing and able to be a part of the microcredit markets.⁹⁴ Indeed, authors have found that this is a market failure because the poor are the most productive users of finance⁹⁵ as are small businesses compared with large businesses.

This failure in the allocation of credit to the most efficient users is arguably a result of the unjustified belief by banks that the poor are a market segment too costly and risky to serve.⁹⁶ With the identification of credit market failure such as in the lack of access to finance for the poor, legal institutions and regulation may be a method to realign the market and encourage microfinance to complete the market.

Traditional financial relationships follow a simplistic model where the bank obtains capital in large bundles, which are dispersed to many borrowers at interest rates which cover the risk of default, transaction costs, and profit.⁹⁷ The target market of microfinance borrowers as being rurally dispersed, illiterate, and generally uneducated members of society⁹⁸ results in a perception that transaction costs remain unbalanced by the return from market interest rates on such small loan balances. The result of this is that the poor do not get access to finance in traditional financial relationships,⁹⁹ and this is a credit market failure, which has led to the development of MFIs to complete the market.

⁹³ See *infra* Part III.

⁹⁴ See, e.g., Shilpa Aggarwal et al., *Financing Businesses in Africa: The Role of Microfinance* (The World Bank Dev. Research Grp., Policy Research Working Paper No. 5975, 2012).

⁹⁵ *Id.*

⁹⁶ This is generally not the case, at least when it comes to the rates of repayment. Hence, the risk is perceived, but not necessarily real. Di Bella, *supra* note 50.

⁹⁷ For a thorough analysis of financial market functioning refer to the thesis of see Deniz Akün, *Banking Regulation in Turkey and Russia: An Economic Analysis* (June 24, 2013) (unpublished Ph.D. dissertation, University of Bologna), available at http://amsdottorato.unibo.it/5328/1/Deniz_Akun_Ph.D_Thesis.pdf.

⁹⁸ See *infra* Part III.

⁹⁹ Arthur Affleck & Mary Mellor, *Community Development Finance: A Neo-Market Solution to Social Exclusion?*, 35 J. SOC. POL'Y 303 (2006).

1. Bank Size

Although the poor have limited access to finance, even in urban environments finance can be limited to two choices: the TML or the MFI.¹⁰⁰ The lack of competition between and within financial providers means that in many ways there is a problem of concentration in the microfinance sector. The research on monopolies has generally found that they result in worse outcomes for the customer.¹⁰¹ In the context of microfinance, this is particularly important because maximizing better customer outcomes are the goal of the microfinance sector.¹⁰² Indeed, even considering the growth of the microfinance sector, with a large number of poor to service, oversaturation of MFIs is still an unlikely reality.

There are a variety of factors which influence access to finance for firms of different sizes. A particular World Bank Report by Beck et al. combined two unique data sets to determine the effect of bank size on access to finance by small firms.¹⁰³ Bank dominance¹⁰⁴ differs between developing countries such as Ukraine, with 99% bank dominance, and Colombia, with 61% of bank dominance. The results of this research are not necessarily consistent with initial intuition in that it was found that a greater number of large banks are associated with lower financial services use by

¹⁰⁰ Walter E. Block, *A Critique of Yunus and His Micro-Finance*, 5 *ECON. MGMT. & FIN. MARKETS* 57 (2010).

¹⁰¹ HAL R. VARIAN, *INTERMEDIATE MICROECONOMICS: A MODERN APPROACH* 6 (W.W. Norton & Co. 8th ed. 2010).

¹⁰² Abdullah Al-Mamun et al., *Examining the Effect of Microcredit on Poverty in Malaysia*, 29 *ASEAN ECON. BULL.* 15 (2012).

¹⁰³ Beck et al., *supra* note 53. These, among others, will be discussed in the following Part. This study used data from the Financial Sector Assessment Program on financial structure and World Bank Enterprise Survey to develop a sample of 54 developing countries and up to 50 countries per regression. These authors matched the samples from both surveys based on indicators developed and made a cross-sectional database. The FSAP authors developed indicators for access to finance, account, overdraft, and loans, with the last three acting as dummy variables. The authors ensured the validity of results by conducting such methodological strategies as controlling for firm-level characteristics which could otherwise affect access to finance such as firm size, public listing, age. The underlying assumption for the methodological design is that some industries rely more on external finance than others for technological reasons and that these differences are consistent across countries.

Using the rigorously constructed database of financial sector and firm data, Beck et al. subsequently built and tested non-linear models using regressions with OLS in order to determine marginal effects of interaction otherwise difficult to interpret.

¹⁰⁴ *Id.* at 3. Bank dominance refers to the percentage of business placed with regulated banks compared to with small-scale specialised lenders (such as MFIs).

firms of all sizes.¹⁰⁵ However, it was found that a greater number of specialised lenders regardless of the financial firm size results in greater access to finance of small firms. These authors discuss the implications of these results in the context of development in developing countries where access to financial services by small firms is critical because they comprise most of the private sector.¹⁰⁶ Further, Beck et al. explain how a particular trend in the size of financial institutions is affected by the regulator because entry barriers and minimum capital requirements affect bank ownership which subsequently affects financial institution size.¹⁰⁷ The effect of this on microfinance is that bank dominance affects credit access, financial system inclusion, and microfinance competition.¹⁰⁸ Thus, from the perspective of these authors, the regulator is in control of the access to finance by small firms through regulating with a particular market structure in mind.¹⁰⁹ This is of direct relevance because it illustrates the control the regulator has on not only the functioning of the microfinance markets, but also of individual MFIs, and intuitively on the financial sustainability of MFIs.

2. Incentives

The law and economics analysis of microfinance will consider the incentives of all the stakeholders in the sector. The incentives to lend and incentives to borrow are an important point for consideration in the market failure discussion.¹¹⁰ From the banks perspective, there are limited incentives to provide loans to the target market of microfinance because of the high perceived transaction costs associated with doing so.¹¹¹ From the borrowers perspective, there may be issues where self-selection bias discourages good borrowers from borrowing under the group-lending

¹⁰⁵ *Id.* at 4.

¹⁰⁶ *Id.* at 2.

¹⁰⁷ *Id.* at 3.

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ See, e.g., Timothy Besley & Stephen Coate, *Group Lending, Repayment Incentives and Social Collateral*, 46 J. DEV. ECON. 1 (1995).

¹¹¹ This is compared with providing a loan to the middle classes or poor above the poverty line. Marek Hudon, *Norms and Values of the Various Microfinance Institutions*, 35 J. SOC. ECON. 35, 38 (2008).

model because of joint liability for loans¹¹² and also where high interest rates exist,¹¹³ which potentially creates a similar “market for lemons”¹¹⁴ where the good borrowers opt-out from microfinance loans. Individual loan contracts for microfinance are thus an innovation, which may increase borrower quality within microfinance loans.¹¹⁵ This, however, does not address the social goals of microfinance, which is not to identify the most suitable borrowers, but to provide credit access to the poor. Indeed, to the contrary, research has found that higher interest rates on individual contracts result in lower loan quality because good borrowers opt-out from applying.¹¹⁶ Adverse selection applied in this way potentially draws lines of similarity between microfinance and regular financial relationship contracts.¹¹⁷

The goals of microfinance would not normally be reached in a market environment without intervention. This is because, although microfinance exists and the growth of borrowing statistics is impressive, the political goals of credit access have yet to be reached.¹¹⁸ Supportive legislation is still required to ensure that MFIs are able to be financially sustainable while achieving development and distributional goals. Given this, the legislator must do something to support microfinance. The development of specific microfinance law in various developing and developed countries is evidence of this already taking place.

MFI legislation may allow MFIs to overcome risk management problems and facilitate market functioning. In order to achieve this, regulation may support Corporate Social Responsibility (CSR) programs, facilitative regulation, or direct regulation, and these will be discussed in subsequent Parts of this article.

¹¹² Malimba Musafiri Papias & P. Ganesan, *Repayment behaviour in credit and savings cooperative societies*, 36 INT’L J. SOC. ECON. 608 (2008).

¹¹³ Hermes & Lensink, *supra* note 4, at F1.

¹¹⁴ See *supra* note 86. This author generally refers to the market for lemons, and the current paper applies that idea to the microfinance sector in this context.

¹¹⁵ See, e.g., Arup Daripa, *Social Capital, Individual Incentives and Loan Repayment* (2009), available at http://www.isid.ac.in/~pu/conference/dec_09_conf/Papers/ArupDaripa.pdf.

¹¹⁶ See, e.g., Hermes & Lensink, *supra* note 4; Karlan & Goldberg, *supra* note 36.

¹¹⁷ As a result of information asymmetry and the self-selection of borrowers, these issues function both in the formal financial sector and also in microfinance.

¹¹⁸ MILLENNIUM CHALLENGE CORPORATION, *Access to Credit Country Scorecards*, <http://www.mcc.gov/pages/selection/scorecards/fy2013> (2013).

III. THE POOR ALSO NEED FINANCE

The model of traditional financial relationships leaves a gap in services provided to the poor. The previous Part established that the banks in developed countries may deem providing credit and other financial services to the poor excessively unprofitable.¹¹⁹ The result of this is a lack of access to capital for the poor as small loan sizes are not offered or applications are rejected.¹²⁰ This situation is relevant across the world, and is especially poignant in developing countries where there are potentially more poor left un-serviced by this market failure. Evidence of this market failure can be found in developed countries where the relatively poor are also excluded from the formal financial system, which has resulted in a trend towards microfinance and microcredit programs across countries such as Holland, Italy and Germany.¹²¹ Poverty is an absolute and a relative socially constructed definition.¹²² It is logical that financial system exclusion exists in all economies, because there will always be a group of people whom banks deem unprofitable because of excessive uncertainty of collateral and repayment ability.¹²³

A. Do the Poor Fit into the Traditional Banking Relationship?

1. Supply Side

a. Trust

Banks in developing countries have greater funding and operational challenges to overcome than banks in developed countries.¹²⁴ Among other

¹¹⁹ Where high transaction costs relative to income earned are small.

¹²⁰ Shafi & Medabesh, *supra* note 21, at 116.

¹²¹ *Microfinance by Country: Italy*, EUROPEAN MICROFINANCE NETWORK, <http://www.european-microfinance.org/index.php?rub=microfinance-in-europe&pg=microfinance-by-country&cpg=22>.

¹²² Muhammad Kashif Khan Durrani et al., *Role of Micro Finance in Reducing Poverty: A Look at Social and Economic Factors*, 2 INT'L J. BUS. SOC. SCI. 138 (2011).

¹²³ Therese Ann Wilson, *Supporting Social Enterprises to Support Vulnerable Consumers: The Example of Community Development Finance Institutions and Financial Exclusion*, 35 J. CONSUMER POL'Y 197 (2012).

¹²⁴ Rusdy Hartungi, *Understanding the success factors of micro-finance institution in a developing country*, 34 INT'L J. SOC. ECON. 388 (2007).

challenges, authors have commented that the level of trust within a country and within the financial sector is particularly important for innovation and outreach to poor customers.¹²⁵ The issue for banks in developing countries is that general levels of trust are relatively low and contract law and enforcement are not always reliable to fill the gap in general trust levels. This is especially relevant for microfinance and, in particular, microsavings. In a low trust environment, it may still be likely that people borrow from MFIs, but the likelihood of them depositing savings is much less likely.¹²⁶

As deposits are the cheapest source of capital, a low trust environment which restricts access to deposits also results in higher operating costs via source of capital, and financial self-sustainability with reliance on donors and governments.¹²⁷

b. Lack of Information

Traditional banking relationships manage risk by collecting a lot of information from customers before and during the provision of financial products.¹²⁸ However, the target customers of MFIs may have no evidence of income, assets, or ability to prove they can repay the loan.¹²⁹ Because of the general lack of information available from microfinance borrowers, there is a very large perceived risk associated with lending to them.¹³⁰ This is particularly the case for traditional banks with no first-hand experience in the high repayment rates of microfinance loans.¹³¹

With technological advances and financial services product innovation, it is becoming easier to provide financial access in developing countries.¹³² For example, in Kenya, which has bank density at one third the density of India, 70% of people use mobile phone banking and bypass

¹²⁵ Aggarwal et al., *supra* note 94.

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ Allen & Gale, *supra* note 31.

¹²⁹ *See supra* Part II.C.

¹³⁰ As discussed in previous Part, this is a perceived risk.

¹³¹ Di Bella, *supra* note 50.

¹³² STATE BANK OF PAKISTAN, POLICY PAPER ON REGULATORY FRAMEWORK FOR MOBILE BANKING IN PAKISTAN (2007), available at http://www.sbp.org.pk/bprd/2007/policy_paper_rf_mobile_banking_07-jun-07.pdf.

traditional banking relationships.¹³³ However, this system is hinged on the requirement of agents to receive and give cash.¹³⁴ The potential scope of microfinance expansion which builds on the use of mobile phone technology is large and countries such as Pakistan have explicit regulatory strategies to build on this technology.¹³⁵

c. Interest Rate

Interest rates on microfinance loans have a global median of 32%.¹³⁶ The rate of interest is generally explainable by higher costs from a lot of small transactions and higher perceived risk to the lender than for traditional collateralised loans as discussed in the previous Parts.¹³⁷ This reasoning, however, is not certain. Further, the interest rate reflects a risk allocation and a risk premium given the demographics of the borrowers and subsequent costs. The primary actions of MFIs and banks when granting loans is to adequately select a borrower who will repay the interest and loan principal and then monitor on-going repayments.¹³⁸ The microfinance model uses community knowledge to select borrowers of low risk by getting recommendations from non-family members.¹³⁹ Further, these recommendations create social pressure on the borrower, which results in them monitoring their own repayments.¹⁴⁰ These two mechanisms build on community knowledge and social pressure and leave the high interest rates attributable to the high proportional operating costs of providing a lot of small loans.¹⁴¹

¹³³ Aggarwal et al., *supra* note 94.

¹³⁴ Herd et al., *supra* note 75.

¹³⁵ STATE BANK OF PAKISTAN, *supra* note 132.

¹³⁶ These results are based on data from 2007 to 2009. Di Bella, *supra* note 50, at 13.

¹³⁷ Arch, *supra* note 16. The real risk of default, however, is low as reported by Di Bella. Di Bella, *supra* note 50, at 13.

¹³⁸ See, e.g., J. Jordan Pollinger et al., *The Question of Sustainability for Microfinance Institutions*, 45 J. SMALL BUS. MGMT. 23 (2007).

¹³⁹ This system works for both individual and group contracts. Rodríguez-Meza, *supra* note 84.

¹⁴⁰ Rahman & Nie, *supra* note 20, at 213.

¹⁴¹ *Id.*

A potential reason for such high interest rates may be MFI inefficiency.¹⁴² That is, despite the facts that borrower recruitment, selection, and monitoring are effectively outsourced to the community,¹⁴³ MFIs fail to be financially sustainable.¹⁴⁴ Given the social objectives of microfinance, it is understandable that NGO funders may monitor and evaluate microfinance performance based on social outcomes rather than the ultimate operational costs and subsequent interest rates.¹⁴⁵ From this it can be logically extended that operating efficiency is not incentivised for MFIs, and the result is high interest rates. The creation of incentives is at the heart of a law and economics analysis of these issues.

However, a trend towards MFIs self-reporting their financial and outreach data to organisations such as the MIX Market Exchange allows that donors can better allocate their funds. This trend creates further issues regarding whether MFIs should be rewarded for being more efficient if there is most likely a trade-off between outreach and efficiency.¹⁴⁶ The relatively low interest rate of microfinance is because of the cheap source of capital which MFIs currently have access to, which allows the transaction costs associated with microfinance to be borne partly by the NGO or government providing the capital.

The interest rates on microfinance loans are generally between 32%–37%.¹⁴⁷ This is relatively high compared to the interest rates charged to middle and upper class borrowers in the same developing countries, which may often be below 10%. However, in comparison to the interest rates charged by loan sharks in the slums of many developing countries,¹⁴⁸ the interest rates of microfinance are relatively cheap. Indeed, microfinance interest rates are not so different from the 20% charged on unsecured credit cards in Australia.¹⁴⁹

¹⁴² See, e.g., Suresh De Mel et al., *Returns to Capital in Microenterprises: Evidence from a Field Experiment*, 123 Q. J. ECON. 1329 (2008).

¹⁴³ In both group and individual based loans. Rodríguez-Meza, *supra* note 84.

¹⁴⁴ See, e.g., Crabb, *supra* note 27.

¹⁴⁵ *Seal of Excellence will help the microfinance sector further its social mission*, MICROCREDIT SUMMIT CAMPAIGN, <http://www.microcreditsummit.org/news/26/seal-of-excellence-will-help.html>.

¹⁴⁶ Hermes & Lensink, *supra* note 4, at F2.

¹⁴⁷ Di Bella, *supra* note 50, at 12–14.

¹⁴⁸ The rate can be as high as 300%. Mayer, *supra* note 24.

¹⁴⁹ COMMONWEALTH BANK OF AUSTRALIA, *Rates and Fees*, <https://www.commbank.com.au/personal/credit-cards/awards/platinum.html#Rates%20and%20fees>.

The issue of microfinance interest rates is a hotly debated opinionated topic rarely covered in the empirical literature. However, a key empirical article by Karlan and Zinman has been published in the *American Economic Review*, which analyses credit-elasticity in microfinance.¹⁵⁰ This research implemented randomised trials in a South African MFI to determine if the poor are sensitive to interest rate changes.¹⁵¹ Importantly, this research found that increasing the interest rate actually results in lower repayment because of higher information asymmetry.¹⁵² In terms of regulatory implications, this research suggests that lower microfinance interest rates result in greater outreach to poor women and at a very small cost to foregone profits. In this way, the research seems to support interest rate caps, although detail is not provided regarding what the interest rate caps should be.

The discussion regarding interest rates is critical to the law and economics discussion of microfinance and will be elaborated in future parts of this article, especially regarding regulatory imposed interest rate caps. If MFI financial self-sustainability is to be achieved, market interest rates need to be charged to borrowers which reflect the cost of providing the product. Indeed, the interest rates currently charged to microfinance borrowers are similar to those charged on uncollateralised credit card loans provided to consumers in developed countries.

Thus, even with cheap sources of capital MFIs still need to charge above 30% interest.¹⁵³ For banks with traditional sources of capital, it can be understood that the interest rate required to cover the high proportional cost of providing loans to the poor would be much higher.¹⁵⁴ This is unless

¹⁵⁰ Karlan & Zinman, *supra* note 88.

¹⁵¹ *Id.* at 1041. The motivation for this is that the authors claim regulation supports MFIs raising interest rates on loans in order to reduce dependence on subsidies, but this strategy only makes sense if the poor are insensitive to interest rate changes. Among key findings, these authors found that loan size was more responsive to a change in loan maturity than changes in interest rates. Long maturities mean there are small monthly repayments and easier cash flow management than short maturities. Hence, this finding is consistent with theory on binding liquidity constraints.

¹⁵² *Id.* at 1064. Borrowers willing to borrow at higher interest rates may arguably have been rejected from other financial institutions because of unsound financial situation or other reasons, which the MFI is unable to know. Hence, information asymmetries are increased with loans with higher interest rates, associated with lower repayment rates.

¹⁵³ Di Bella, *supra* note 50.

¹⁵⁴ *Id.* This explains the discrepancy in interest rates between loans for the rich and the poor.

the need to access the financial and investment markets in itself creates operating efficiencies brought about by the process of on-going regulation.

d. Alternatives—Supply Not Diversified

For the poor and chronic poor who need access to finance to smooth consumption expenses or fund businesses, there are few avenues to choose from. Some poor are willing and able to pay for access to finance,¹⁵⁵ although the chronic poor are not.¹⁵⁶ This is illustrated in the widespread use of TMLs¹⁵⁷ by the poor across the world.¹⁵⁸ It is logical that the loan sharks who dominate the slums and chronic poor areas should not be the first choice of potential borrowers because of high interest rates and violent repayment tactics.¹⁵⁹ Authors have found a paradox in that the flexibility of repayments for services by loan sharks means that it is not uncommon for borrowers to choose these loans rather than the rigid payment schedules of microfinance.¹⁶⁰ In a continually adapting microfinancial services market, there exists a role for TMLs and loan sharks in providing flexible loans, despite the high interest rates. This is an issue because it illustrates that there is a gap in the traditional market and microfinance has not been designed in a sufficiently adequate manner to complete the gap. However, with low awareness of microfinance, especially in areas such as sub-Saharan Africa¹⁶¹ where the need is great means that the poor are effectively left with no choice.

In a smoothly functioning financial market, there should theoretically be a variety of credit access sources that the poor can use, because where there is demand a market should appear.¹⁶² This is because the poor are

¹⁵⁵ See, e.g., Aggarwal et al., *supra* note 94; Di Bella, *supra* note 50.

¹⁵⁶ Samia Mahmood, *Microfinance and Women Entrepreneurs in Pakistan*, 3 INT'L J. GENDER & ENTREPRENEURSHIP 265 (2011).

¹⁵⁷ Traditional Money Lenders (TMLs) such as payday lenders or informal finance sources.

¹⁵⁸ See, e.g., Amadi, *supra* note 52; Francis Kehinde Emeni, *Microfinance Institutions in Nigeria: Problems and Prospects: Questionnaire Survey Findings*, 21 J. FIN. MGMT. & ANALYSIS 69 (2008).

¹⁵⁹ Emeni, *supra* note 158.

¹⁶⁰ See, e.g., Hudon, *supra* note 111; Dean Karlan & Sendhil Mullainathan, *Is Microfinance Too Rigid?* (forthcoming) (on file with author); Pearlman, *supra* note 77.

¹⁶¹ Aggarwal et al., *supra* note 94.

¹⁶² For a general sense for the basic idea of supply and demand, see John Maynard Keynes, *The General Theory of Employment*, 51 Q. J. ECON. 209 (1937).

willing and able to pay for access to credit,¹⁶³ and the best evidence for this is the use of loan sharks across the world.¹⁶⁴ Despite the fact that loan sharks are not able to outsource the selection and monitoring of borrowers in the way MFIs are, their continued existence seems to indicate that providing finance to the poor can be a profitable business.

Across the world the most common source of credit is from family and friends.¹⁶⁵ Thus, although there is a source of credit, there is no supply diversification, nor is this supply method efficient.¹⁶⁶ This illustrates not only cultural issues and aversions to financial institutions, but also the low awareness and uptake of microfinance. An additional interpretation is that this shows there is a great demand for financial services by the poor.¹⁶⁷ Hence, non-diversified access to credit results in fewer choices from lower competition and ultimately less efficient financial service access.

2. Demand Side

a. Cash Flow but No Savings

The financial situation of microfinance borrowers provides an explanation for why most microfinance is used to smooth consumption expenses rather than to fund microenterprises. The target market of microfinance is the poor who have cash flow to cover expenses as they arise, but have no “nest-egg” to provide for a “rainy day” or unexpected or large expenses such as medical expenses or expanding a business.¹⁶⁸

It is intuitive that people with a small amount of cash flow but no savings may need to borrow funds to pay for lump sum expenses such as education or medical costs. Indeed, humanities’ general risk averse

¹⁶³ Aggarwal et al., *supra* note 94.

¹⁶⁴ Pearlman, *supra* note 77.

¹⁶⁵ Herd et al., *supra* note 75.

¹⁶⁶ Examples include extreme weather or economic catastrophes, which result in this credit source disappearing.

¹⁶⁷ Indeed, with over 70% of loans from family, there are potentially wide-ranging implications in an economic shock which would surely hurt all members of society with inter-community loans, and also restrict loans to cover the unexpected bad circumstances, which at an individual level a society can deal with. Pearlman, *supra* note 77.

¹⁶⁸ Brau & Woller, *supra* note 48.

tendencies¹⁶⁹ indicate that even a better personal financial situation may not be enough to shift the use of microfinance from consumption to entrepreneurship.¹⁷⁰

b. Vulnerability to External Shocks

Prior to the Global Financial Crisis (GFC), MFI investment was an asset class for inclusion in investment portfolios providing sound diversification because of the general insulation from international markets and lower financial leverage than banks.¹⁷¹ This risk diversification benefit allowed microfinance to attract investment as well as donor funds, and the impact on borrowers was steady growth in outreach. In an IMF Working Paper, Di Bella¹⁷² examined the effect of the GFC on microfinance, in particular the systemic risk faced by MFIs.¹⁷³

Di Bella found that as MFIs trend away from the traditional funding sources of Non-Government Organisation (NGO) funds, there is increased exposure to changes in domestic and international economic conditions.¹⁷⁴ The implications of this are large, especially for countries such as Peru, Bolivia, and Kenya where microfinance composes a large percentage of total Gross Domestic Product (GDP). This paper found that the MFI transformation from being unregulated to regulated invariably results in an increase in systemic risk.¹⁷⁵ It can be simply and intuitively extended that the increased vulnerability to external shocks, which MFIs face from

¹⁶⁹ Arndt Sorge, *Culture's Consequences: International Differences in Work-Related Values*, 28 ADMIN. SCI. Q. 625 (book review) (discussing general human tendencies away from uncertainty).

¹⁷⁰ W. Jean Kwon, *An Analysis of Organisational, Market and Socio-Cultural Factors Affecting the Supply of Insurance and Other Financial Services by Microfinance Institutions in Developing Economies*, 35 GENEVA PAPERS ON RISK & INS. 130 (2010).

¹⁷¹ Nicolas Krauss & Ingo Walter, *Can Microfinance Reduce Portfolio Volatility?*, 58 ECON. DEV. & CULTURAL CHANGE 85 (2009).

¹⁷² Di Bella, *supra* note 50.

¹⁷³ *Id.* This author sampled 353 MFIs who conformed to a set of criteria regarding size and the consistency of data over the last seven years, and grouped for analysis into geographical regions. In determining the performance of MFIs, the authors used asset and lending growth, return on equity, portfolio at risk, and write-off ratios. This paper examined the systemic risk of MFIs over a nine year period during which the GFC also occurred. The methodology of OLS panel regressions and general regressions seem to be robust given the measures taken to ensure there are no other influencing factors involved.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

having other funding sources, may spread the financial troubles of international markets to the front door of marginalised microfinance borrowers in developing countries. That is, international crises which previously did not greatly affect NGO-funded MFIs now may result in reduced access to credit for small, rurally dispersed business people and families all over the developing world. This paper uncovered a number of other significant findings in relation to regulation, MFI financial sustainability, and the differences between regulated MFIs and non-regulated MFIs.¹⁷⁶

c. High Interest Rates for Loan Sharks

Although there is a demand for credit access among the poor, there are limits as to how much they are able to pay for the service.¹⁷⁷ Despite the prevalence of loan sharks, the poor are not necessarily able to pay the high interest rates on loans from loan sharks which can be as high as 300%.¹⁷⁸ This is because high interest rates effectively increase the regular outlay that borrowers have to integrate into their future cash flow.¹⁷⁹ Given that the poor already have limited cash flow, which does not allow for the saving of funds for future expenses, it is logical that high interest rates are not affordable for many, and may result in a debt-trap.¹⁸⁰

B. Typical Microfinance Loan

A typical microfinance loan is very different from a typical loan in traditional financial relationships. In particular, microfinance borrowers have no collateral, no financial security, no financial history, low technological ability, unreliable identification, and low literacy levels.¹⁸¹ As

¹⁷⁶ *Id.*

¹⁷⁷ Charles Okeahalam, *Economics of Access in a Developing Country: An Analysis of Firm-conduct in Financial Services*, 34 INT'L J. SOC. ECON. 923 (2007).

¹⁷⁸ Mayer, *supra* note 24.

¹⁷⁹ As interest rates increase, so do the regular repayments of the loan.

¹⁸⁰ Karen E. Francis, Note, *Rollover, Rollover: A Behavioral Law and Economics Analysis of the Payday-Loan Industry*, 88 TEX. L. REV. 611 (explaining a "debt-trap" is when borrowers take more and more loans to pay the interest and capital on previous loans).

¹⁸¹ See, e.g., Brau & Woller, *supra* note 48.

identified in the previous discussions, microfinance loans differ from traditional loans in that there is supply side risk, demand side risk, high levels of uncertainty,¹⁸² and there are high interest rates charged. The design of microfinance contracts in this way addresses the supply and demand side issues. The relatively high interest rates charged reflect the high costs of serving the poor through microfinance despite the capital provided by NGO's. Organisations such as Microfinance Transparency¹⁸³ serve the sector by examining how product features, such as forced savings, and when the first repayment begins affect the real cost of the loan. With low financial literacy, many borrowers are unlikely to be aware of how product features can affect the real cost of the loan.¹⁸⁴

The differences between borrowers illustrate that traditional financial relationships would need to adjust greatly to account for microfinance borrowers and loans. Given these differences in borrower demographics it can be understood that credit availability to the poor would not increase without MFIs. Authors have discussed that microfinance is a financial innovation which increases the repayment probability of uncollateralised loans.¹⁸⁵ Indeed, prior to microfinance, an innovation with similar results in both social outcomes and high repayments was not institutionalised.

Unlike traditional banks, MFIs do not generally acquire capital in a traditional sense, such as from capital markets, but rather acquire it from low interest loans or donations.¹⁸⁶ Most MFIs are not publicly listed and are funded primarily from donor funds,¹⁸⁷ with the exception of MFIs in Peru, Bolivia, and Pakistan where they are also funded by deposits and equity partnerships.¹⁸⁸ This means that equity from shareholders is not a reliable source of capital to use to lend to the poor. Thus, most capital is required to

¹⁸² KNIGHT, *supra* note 86 (explaining levels of uncertainty differ from risk because uncertainty is unquantifiable).

¹⁸³ ABOUT MICROFINANCE TRANSPARENCY, <http://www.mftransparency.org/about-our-organization/>.

¹⁸⁴ Nathalie Holvoet, *Impact of Microfinance Programs on Children's Education*, 6 J. MICROFINANCE 27 (2004).

¹⁸⁵ Buera et al., *supra* note 17.

¹⁸⁶ Nelson Waweru & Gary Sprakman, *The Use of Performance Measures: Case Studies from the Microfinance Sector in Kenya*, 9 QUALITATIVE RES. IN ACCT. & MGMT. 44 (2012).

¹⁸⁷ See, e.g., Di Bella, *supra* note 50.

¹⁸⁸ Economist Intelligence Unit, *Global Microscope on the Microfinance Business Environment 2013*, THE ECONOMIST (2013).

come from large loans from NGO's, governments, or donations¹⁸⁹ despite the fact that many MFIs do seek operational sustainability¹⁹⁰ given their particular sources of capital. In some countries, the legislation allows regulated MFIs to also accept deposits, which creates another source of capital.¹⁹¹ Indeed, savings as a source of capital seems to be the most promising development which will allow MFIs to be financially self-sustainable without having high exposure to changing international economic conditions.¹⁹²

Innovations in distribution¹⁹³ are allowing MFIs to reach an increasing number of target borrowers while keeping financial and operational costs low enough to be sustainable with subsidised credit available. MFI innovation is specific to the regulatory environment in which they operate¹⁹⁴ and the trend is towards streamlined loan provision processes¹⁹⁵ and leveraging off innovations in technology.¹⁹⁶ However, the rate of innovation in efficiency and distribution is not currently at a pace which reflects the growth of MFIs and this may reflect the social goals of microfinance (rather than financial sustainability) or the lack of internal and external innovation pressure.¹⁹⁷

¹⁸⁹ This is in contrast to the operations of financial institutions in the formal financial sector, where banks use their large deposit base to provide loans and fund their operations. This was discussed in Part II. In contrast, MFIs do not have such reliable sources of capital, relying often on donations, or if they seek capital on the international capital markets, then they are exposed to currency and financial shock risk to an extent that they may not be able to deal with that risk. Di Bella, *supra* note 50.

¹⁹⁰ The difference between self-sustainability and operating sustainability is that operating sustainability is limited to being able to continue operations without relying on donations or low interest loans. Financial self-sustainability on the other hand refers also to the ability to expand operations based on the MFIs own internal resources, which includes seeking capital at market interest rates: Valentina Hartarska & Denis Nadolnyak, *Do Regulated Microfinance Institutions Achieve Better Sustainability and Outreach? Cross-Country Evidence*, 39 APPLIED ECON. 1207 (2011).

¹⁹¹ Economist Intelligence Unit, *supra* note 188.

¹⁹² Shafi & Medabesh, *supra* note 21, at 116.

¹⁹³ Mehr Shah, *Regulating Pakistan's Non-Bank Microfinance Institutions*, 14 PAKISTAN MICROFINANCE NETWORK (2011) (discussing mobile phone repayments).

¹⁹⁴ Satta, *supra* note 42 (discussing how regulation can restrict product designs such as loans requiring collateral).

¹⁹⁵ See, e.g., Thorsten Beck & Ross Levine, *Legal Institutions and Financial Development* (Nat'l Bureau of Econ. Res., Working Paper No. 10126, 2003).

¹⁹⁶ See, e.g., Herd et al., *supra* note 75.

¹⁹⁷ See, e.g., Geoffrey R. Archer & Lisa Jones-Christensen, *Entrepreneurial Value Creation through Green Microfinance: Evidence from Asian Microfinance Lending Criteria*, 10 ASIAN BUS. & MGMT. 331 (2011); Marion Mbogo & Caroline Ashika, *Factors Influencing Product Innovation in*

The majority of microfinance loans are provided in a model of group lending which harnesses the power of social pressure.¹⁹⁸ For example, group loans may be provided to a group of five women from the same village, generally neighbours.¹⁹⁹ Loans are provided to the group and although they borrow individually, they are jointly liable for each other's loans within the group.²⁰⁰ This model harnesses the power of social pressure, especially in developing countries where a sense of community²⁰¹ is often higher than in developed countries.²⁰² Indeed, individual loans are also designed to harness social pressure because of a requirement for "recommendations," if not joint liability, from other community members.²⁰³ These models bypass the need for collateral or information about the borrowers' abilities to repay the loans because each borrower is selected by community members willing to stake their reputation on repayment.²⁰⁴ However, although microfinance has been founded on the model of group lending and joint liability, the trend is moving away from this model.²⁰⁵ Indeed, research has found that individual loan repayment rates are comparable to group loans when structured correctly around social pressure.²⁰⁶

These operational structures of MFIs and microfinance loans allow the gap in the market to be theoretically filled and the poor are able to access

Micro Finance Institutions in Kenya: A Case Study of MFIs Registered With the Association of Microfinance Institutions (2011), available at <http://sbaer.uca.edu/research/icsb/2011/390.pdf>.

¹⁹⁸ Nidhiya Menon, *Interdependencies in Microcredit Groups: Evidence from Repayment Data*, 40 J. DEVELOPING AREAS 111, 112 (2007).

¹⁹⁹ *Id.* at 115.

²⁰⁰ *Id.* at 113.

²⁰¹ GEERT HOFSTEDÉ, *CULTURE'S CONSEQUENCES: INTERNATIONAL DIFFERENCES IN WORK-RELATED VALUES* (2d ed. 2001) (analysing "collectiveness").

²⁰² *Id.*

²⁰³ See, e.g., R. Cull et al., *Contract Design and Microfinance Performance: A Global Analysis* (World Bank Pol'y Res., Working Paper No. 3827, 2006).

²⁰⁴ *Id.*

²⁰⁵ Some of the world's largest MFIs have moved away from group lending models towards individual contracts, such as the Grameen Bank. GRAMEEN BANK, *GRAMEEN BANK'S RESPONSE TO THE VARIOUS ISSUES RAISED IN THE REVIEW COMMITTEE REPORT AS REPORTED IN THE PRESS* (2011).

²⁰⁶ See, e.g., X Xavier Giné & Dean Karlan, *Group Versus Individual Liability: Long Term Evidence from Philippine Microcredit Lending Groups* (Yale Econ. Dep't Working Paper No. 61 2006).

credit. There are further contract specifications which increase the loan security while allowing that the social goals of microfinance are met.²⁰⁷

IV. EFFECTIVENESS AND DISTRIBUTION

Based on the previous two Parts it has been illustrated that there is a policy problem which results in no credit being made available to the poor in a traditional financial market. Based on the reasons in Part II, political goals of credit availability are not realised without MFIs.

Governments are interested in microfinance because of the social goals identified in the third Part of this paper. There are wide ranging female empowerment, financial inclusion, and mental health benefits from microfinance, which assist governments in equity goal achievement.²⁰⁸ However, the current article is concerned with testing the effectiveness of laws in promoting microfinance. This article is not claiming that microfinance is for efficiently achieving political goals.²⁰⁹ Thus, this article contains an effectiveness study which entails determining how to affect the incentives of stakeholders to promote microfinance via financially sustainable MFIs.

The issues that are relevant for the effectiveness discussion of microfinance are that there is a need in the market that people want finance and they cannot get access to it.²¹⁰ It needs to be determined whether this lack of access to finance is because of regulatory or market failures. However, regardless of where the issue lies, development goals of financial inclusion are not met without MFIs.²¹¹ This is because political development goals of female empowerment and entrepreneurship are

²⁰⁷ Loans are generally provided to females and on fixed repayment schedules, with social collateral an underlying factor. Marek Hudon, *Should Access to Credit be a Right?*, 84 J. BUS. ETHICS 17, 19 (2009); *Access to Credit, Country Scorecards*, MILLENNIUM CHALLENGE CORPORATION (Oct. 24, 2014 1:00 PM), <http://www.mcc.gov/pages/selection/scorecards>.

²⁰⁸ See, e.g., Mahmood, *supra* note 156.

²⁰⁹ That is outside the scope of the current paper, which is limited to the role of incentives in regulation and microfinance.

²¹⁰ Hudon, *supra* note 207, at 17.

²¹¹ Al-Azzam et al., *supra* note 12, at 12.

reached via credit availability.²¹² It is relevant to identify at this stage whether microfinance is an effective instrument at reaching the political goal of credit availability.

A. Policy Problem

It is a policy problem regarding whether microfinance provides the effectiveness of reaching the political and distributional goals of access to credit for low income people. If microfinance helps achieve political goals, then it is logical for governments to provide legislation which supports MFIs in achieving those goals. The converse, however, is also true. Previous Parts of this article have established that microfinance is a solution to the policy problem which various social, regulatory, and economic government initiatives seek to address.

The effect of microfinance is only as strong and long-lasting as the foundations on which it is built. Regulation has the potential to promote or restrict microfinance penetration across the world. Indeed, authors have found that incomes differ across countries not because of knowledge, capital markets, population, natural resources, human capital, or culture, but because of differences in the quality of institutions and economic policies.²¹³ This is the focus of the current article—ways in which regulation and institutions can be designed to promote microfinance and thus access to credit. Other authors have also commented that economic growth and poverty alleviation are not possible in societies without strong institutions.²¹⁴ There has been much debate on this topic in the past, and this issue is not directly related to the current article. As such, the effect of regulation and legal institutions will be assumed to exist and the analysis will move forward from there.

²¹² Ekpe et al., *supra* note 47, at 235; see also Paromita Sanyal, *From Credit to Collective Action: The Role of Microfinance in Promoting Women's Social Capital and Normative Influence*, 74 AM. SOC. REV. 529, 530 (2009).

²¹³ Marieur Oison, *Big Bills Left on the Sidewalk: Why Some Nations are Rich, and Others are Poor*, 10 J. ECON. PERSP. 3, 7 (1996).

²¹⁴ See, e.g., Arch, *supra* note 16.

B. Distribution

The problem of microfinance success can alternatively be defined as one of distribution. This is because development and social goals are political and not efficiency based, but that does not mean that the goals should not be achieved. From this perspective, the core aim of microfinance is exposed as credit availability. Through the distribution of microfinance, credit availability will increase.²¹⁵ Indeed, it is the distribution of credit to those in rural areas and of the chronic poor which is the aim of microfinance.²¹⁶ This has potential distribution effects to the wider population.

Authors have empirically found that microfinance results in increased wages across the board and as such, has a redistributive and welfare effect on the economic development of developing countries.²¹⁷ This trend indicates that through the achievement of access to credit, development can also be increased in certain areas.

C. Measurement of Microfinance Effectiveness

In order to measure the effectiveness of microfinance, it is critical that clearly defined benchmarks are developed. This is particularly the case with development goals where a range of associated factors make the effect on development difficult to isolate.²¹⁸

Given the political goals of microfinance and the previous analysis of impact, it can be seen that there is inconsistent evidence regarding the success of microfinance, given that that success depends on which benchmarks it is measured against. Based on the benchmarks identified, political goals around poverty alleviation and social goals of financial

²¹⁵ See, e.g., G. Berg, *Funding vs. Real Economy Shock: The Impact of the 2007–2009 Crisis on Small Firms' Credit Availability* (Policy Research Working Paper 6030, 2012).

²¹⁶ See, e.g., Manoranjan Sharma, *Emerging Contours of Micro Finance: Where Do We Go From Here?*, 4 BUS. REV., CAMBRIDGE 288 (2005).

²¹⁷ See, e.g., Buera et al., *supra* note 17.

²¹⁸ See, e.g., Stanislav Kolenikov & Gustavo Angeles, *Socioeconomic Status Measurement with Discrete Proxy Variables: Is Principal Component Analysis a Reliable Answer?*, 55 REV. INCOME & WEALTH 128, 129 (2009).

inclusion and distribution have been partially met.²¹⁹ Regarding poverty alleviation, the research has indicated that only 1% of borrowers each year are lifted out of poverty,²²⁰ yet most borrowers are female and there are high levels of increased empowerment across countries.²²¹ Other authors have found that 1.5% of borrowers were lifted out of poverty between the years of 1991 and 1992 and 1998 and 1999 in Bangladesh.²²² However, the long-term effects of microfinance are complicated to establish empirically because loan terms are generally so short the direct effect cannot be reliably confirmed, and most borrowers do not continue to take further loans.²²³ Indeed, the movement of a large number of people in and out of poverty²²⁴ make the effect on poverty even more complicated to measure. Thus, many empirical papers seeking to examine microfinance success and MFI performance have measured different proxies making blanket conclusions challenging.

1. Parameters to Measure Microfinance Success

In determining the success of MFIs or of the impact of microfinance, it is important to establish criteria by which success can be measured. There are a range of factors integral to the focus and motivation of MFIs, and there are other factors which are deemed important by external observers or those seeking long-term success.²²⁵ Thus, depending on the perspective from which microfinance is viewed, benchmarks for success may be

²¹⁹ See *supra* Part IV.C.2–IV.C.3.

²²⁰ Khaled Shukran & Farhana Rahman, *A Grameen Bank Concept: Micro-Credit and Poverty Alleviation Program in Bangladesh*, INT'L CONF. ON EMERGING TRENDS IN COMPUTER AND IMAGE PROCESSING 47 (2011).

²²¹ See, e.g., Linda Mayoux, *Questioning Virtuous Spirals: Micro-finance and Women's Empowerment in Africa*, 11 J. INT'L DEV. 957 (1999).

²²² Shahidur R. Khandker, *Microfinance and Poverty: Evidence Using Panel Data from Bangladesh*, 19 THE WORLD BANK ECON. REV. 263, 273 (2005). The calculations indicate that it is approximately 1.5 million people per year lifted out of poverty as a result of microfinance.

²²³ Sharma, *supra* note 216.

²²⁴ Bob Baulch & John Hoddinott, *Economic Mobility and Poverty Dynamics in Developing Countries*, 36 J. DEV. STUD. 1 (2000).

²²⁵ Waweru & Spraakman, *supra* note 186.

developed differently. For the purposes of the current research, it is the regulatory success or failure which is of most relevance.²²⁶

Microfinance success is access to credit for the purpose of the current article. If there is access to credit, then potentially there can be reductions in poverty and increases in economic development, along with well-established social benefits. However, this article is concerned with examining the effectiveness of regulation and legal institutions in increasing access to credit via microfinance promotion. The reason for this focus is because access to credit is a political goal.

The current research is primarily concerned with the measurement of the success of microfinance in achieving the goals of the regulator. Microfinance laws, as with other sector specific laws, are created with specific goals in mind. These goals are not always obvious, but indeed laws are not created arbitrarily.²²⁷ The goal of the law is integral in determining by which benchmarks effectiveness is measured: laws designed to provide social outcomes need to be measured against social benchmarks and the same exists for economically motivated laws.²²⁸ If indeed it is not the case that regulation promotes microfinance, then the factors which do influence the role of law, such as interest groups or psychology, need to be examined and identified. These issues are outside of the scope of the current article.

The establishment of MFIs as poverty reduction mechanisms via the effective use of credit and entrepreneurship in itself provides ambiguous benchmarks from which a comparison can be made.²²⁹ Indeed, the definition of poverty is based on what is socially acceptable.²³⁰ Thus, the shifting goalposts which define poverty is an important consideration for the current research. It may be the case that even as every person is reached by microfinance and average wages increase tenfold, the new measure of poverty requires a never ending loop of poverty reduction.²³¹ However, this

²²⁶ This relates to how regulation affects MFIs and lets them be able to do the work they want to do; giving loans to the poor.

²²⁷ A. Allott, *The Effectiveness of Laws*, 15 VAL. U. L. REV. 229, 231 (1981).

²²⁸ Anthony Kyereboah-Coleman & Kofi A. Osei, *Outreach and Profitability of Microfinance Institutions: The Role of Governance*, 35 J. ECON. STUD. 296 (2008).

²²⁹ This is because access to credit and entrepreneurship are inherently difficult to define and measure.

²³⁰ Jamaluddin Husain, *Role of Micro-Finance Institutions in Reducing World Poverty: An Overview*, 11 BUS. REV., CAMBRIDGE 38 (2008).

²³¹ *Id.*

consideration is broadly considered as philosophical in nature because there are many social and economic factors such as corruption, religion, women's rights, and politics which ensure that there are challenges for even the initial goals of microfinance to be achieved.

Given that the goal of microfinance is to increase the socioeconomic conditions of the world's poor this may be used to develop a benchmark.²³² In particular it may be stated that at least 1.5% of microfinance borrowers need to be lifted out of poverty per year, which is the benchmark of poverty reduction measured by Khandker.²³³ However, given the nature of microfinance borrowers, this data may have reliability issues.²³⁴ Indeed, the factors which result in borrowers being lifted out of poverty are many and difficult to isolate on a large scale with rigorous empirical methodology.²³⁵ There is a trend in microfinance to measure the effect of the loans, called the Seal of Excellence,²³⁶ where social and economic outcomes are quantified.

Further, qualitative measures of microfinance regulatory success can be used to complement quantitative measures. For example, the relative reach of microfinance in serving those who are in most need of services is a measure of which data is unavailable.²³⁷ Qualitative analysis can thus complement the results of this article because of selection bias and issues of awareness, which potentially skew quantitative results.

2. Benefits of Microfinance

a. Poverty Reduction from Microfinance

Microfinance has developed and provided outcomes for the world's poor, which are measurable as small statistical increases in socio-economic

²³² This, ideally, would relate to the goal of microfinance.

²³³ Khandker, *supra* note 222.

²³⁴ Waweru & Spraakman, *supra* note 186.

²³⁵ *Id.*

²³⁶ *Microfinance Summit Campaign: Seal of Excellence*, MICROFINANCE-SUMMIT (Oct. 24, 2014, 12:00 PM), <http://www.microcreditsummit.org/news/26/seal-of-excellence-will-help.html>.

²³⁷ See, e.g., Paul Collier & Partha Sarathi Dasgupta, *Poverty Reduction in Africa*, 104 PNAS PROC. OF THE NAT'L ACAD. OF SCI. OF THE U.S. OF AM. 16763 (2007). That is to say that the rural villagers and other "Bottom of the Pyramid" poor are still un-served by microfinance but there are only vague estimates as to the number of people still un-served, generally based on poverty statistics.

benefits. Research has indicated that 1% to 1.5% of microfinance borrowers are lifted out of poverty each year.²³⁸ Considering the historical increases in the amount of microfinance borrowers per year, this indicates a positive result. This is because it is the ability of microfinance to serve millions of people rejected by the traditional financial system which provides its true potential in achieving socioeconomic goals. When we consider the number of borrowers served by microfinance thirty years ago, we can see that the figure of 1.5% being lifted from poverty each year²³⁹ is quite small when there are only a few million borrowers. Now, however, there are millions of borrowers all over the world.²⁴⁰ The benefit to society as a whole is increasing constantly. The result of this is an estimated 1 million to 1.5 million microfinance borrowers per year lifted out of poverty.²⁴¹

This increasing outreach to more and more borrowers also indicates that the overall impact on microenterprises is also growing. If, for example, only 1% of borrowers “graduate”²⁴² from consumption based loans to obtaining loans to microenterprises, this is a disheartening result for those who plan on microfinance being the economic driver of development. However, when the increasing amount of borrowers is considered, this figure connotes a much more positive result.²⁴³

The economic development of developing countries has lagged behind theoretical models considering the provision of microfinance and donor funds.²⁴⁴ World Bank reports have found that the economic gains from microfinance are lower than would be expected.²⁴⁵ There is, however, an overall increase in wages.²⁴⁶ Other authors have found that microfinance results in income generation and does reduce poverty in small degrees.²⁴⁷

²³⁸ Khandker, *supra* note 222.

²³⁹ *Id.* at 284.

²⁴⁰ Satta, *supra* note 42.

²⁴¹ Khandker, *supra* note 222, at 285 (The author used calculations of 1.5% of borrowers and there are approximately 100 million borrowers.).

²⁴² As discussed previously, this is when microfinance borrowers move from small microfinance loans to being a part of the formal financial system.

²⁴³ Although only 1.5% of borrowers may be lifted out of poverty each year, the real numbers of 1.5 million borrowers is difficult to overlook as a small effect on poverty.

²⁴⁴ Shukran & Rahman, *supra* note 220.

²⁴⁵ Aggarwal et al., *supra* note 94.

²⁴⁶ Buera et al., *supra* note 17.

²⁴⁷ Durrani et al., *supra* note 122.

However, in an empirical economic sense the success of microfinance²⁴⁸ is supported in only a handful of published papers and thus the results should be interpreted with caution. However, theoretical arguments continue to support microfinance as a method to support micro entrepreneurship and this may have future economic benefits.²⁴⁹

b. Macroeconomic Perspective

Microfinance as a financial intervention is now of sufficient scale to allow general equilibrium analysis of the economic effects. In particular, a study by Buera et al.²⁵⁰ looked at the effects of microfinance by examining microfinance and credit programs targeted at small business.²⁵¹ The most significant finding of this particular research is that not just microfinance borrowers, but most people are positively affected in an economic sense by microfinance because of increases in equilibrium wages.²⁵²

²⁴⁸ The success of microfinance for the current article is taken to mean the socioeconomic benefits of the intervention.

²⁴⁹ Buera et al., *supra* note 17.

²⁵⁰ *Id.* These authors examined the general equilibrium (GE) and partial equilibrium (PE) effects.

²⁵¹ *Id.* The methodology for this empirical paper is built on including endogenous saving rates between entrepreneurs and workers and high and low ability people. This limited scope of analysis excludes microfinance loans for consumption and may have less generalized results because of this. Further, the exclusion of consumption loans results in an under-prediction of consumption increases attributed to microfinance and the resulting flow-through effects on the economy. This study uses a model of entrepreneurship where financial development results in large aggregate impacts.

²⁵² *Id.* Under General Equilibrium analyses, the research by Buera et al. found an increase in aggregate TFP. However, these authors also found that the increase in TFP is counterbalanced by a reduction in capital accumulations, that is, savings, because of the high redistributive impact of microfinance from savers to non-savers because of the increase in wages and interest rates. The implication of this is that the scaling up of microfinance programs will lead to a small per-capita increase in income. Despite this, there are still significant aggregate and distributional impacts of microfinance. Importantly, general equilibrium analyses also found increases in equilibrium wages and interest rates. Thus, under GE, microfinance affects marginal entrepreneurs directly, workers indirectly, through higher wages, and may hurt business people or the rich because of an increase in factor prices. However, given that the aim of microfinance is in essence wealth distribution, this may actually be a bonus result.

Buera et al. also examined the macroeconomic effect of microfinance based on a partial equilibrium analysis. A PE analysis assumes that wages and interest rates, among other assumptions, remain constant, whereas a GE analysis allows theoretical changes in defined associated inputs. Although not as easily generalized to the real economic situation, these PE results did find higher increases in aggregate output and capital than under GE assumptions. Further, the increased rate of entry of productive entrepreneurs into the market resulted in an increase of capital and labour demand and output, with subsequent results being lower aggregate TFP than under GE analyses. Further, there were

The paper by Buera et al., published by the National Bureau of Economic Research, is important in establishing the effect of microfinance on economic development.²⁵³ The GE effects of increased wages show a redistributive effect which leads to an increased welfare effect. Thus, although previous studies have focussed on the absolute change in poverty of borrowers, this study allows for nuanced effects such as relative wage increases to be discussed.

c. Economic Gains from Microfinance

A variety of economic literature supports the need for small businesses to have access to finance in order to achieve long-term economic growth. Recent research published by The World Bank by Aggarwal et al. examined the role of microfinance on the access to credit of small businesses in Africa.²⁵⁴

The research by Aggarwal et al. finds mixed support for microfinance in terms of economic gains.²⁵⁵ On the one hand, the research does show that access to finance results in business growth. However, on the other hand the results also indicate that the economic gains from microfinance are lower than were theoretically expected because of the mobilisation of household savings and empowerment from financial service access, and that the only certain positive outcome from microfinance is the smoothing of consumption expenses. Indeed, following this trend the authors highlight

greater magnitude impacts on consumption and output, business starts, capital inputs, and labour inputs and outputs than under GE.

²⁵³ *Id.*

²⁵⁴ This paper uses the 2009 and 2010 Gallup World Poll data which includes 150,000 people from 157 countries and asks questions regarding demographics, well-being, income, politics, and financial inclusion. These authors used the data from this survey to compare the findings of the literature and draw conclusions which support the development of micro-savings innovation. However, despite the research paper using original data from the Gallup World Poll, the conclusions drawn by the paper relate to the potential for savings accounts rather than any conclusions drawn from the actual data analysis. The data analysis has been made at a descriptive level, and although providing some very interesting summaries of the Gallup World Poll and the implications on microfinance in sub-Saharan Africa, nonetheless few results are provided which contribute to filling the gap in the literature in this field. Aggarwal et al., *supra* note 94.

²⁵⁵ *Id.*

the economic drawbacks of microfinance²⁵⁶ and provide evidence that suggests the promotion of methods for saving would be more efficient at reducing poverty in sub-Saharan Africa than loans: a result at odds with the research by Bauer et al.²⁵⁷ These authors find that borrower heterogeneity means that microfinance does not actually help to create new businesses on average, a result supported by Ahlin and Jiang.²⁵⁸

A key theoretical paper on the topic of the long-term economic effects of microfinance has been published by Ahlin and Jiang in the *Journal of Development Economics*.²⁵⁹ However, these authors found that the key to long-term microfinance success is the “graduation rate.”²⁶⁰ The model analysis showed that microfinance “graduates” who achieve long-term benefits come as often from saving as from having business success. The implications of these findings are that the quality of microfinance loans needs to be increased through increasing the productive efficiency of self-employed borrowers through information sharing, technological transfer, and training programs. Further, these authors suggest that MFI loan officer incentives and MFI evaluations be structured around the requirement for “graduation” of borrowers as well as outreach and social benefits.²⁶¹ Importantly, this theoretical discussion highlighted the interconnectedness between microfinance, microsavings, and long-term poverty reduction.

d. Micro-Entrepreneurship

The theoretical economic success of microfinance lies in its ability to mobilise the household savings of the poor to provide loans for entrepreneurs to start or grow small businesses.²⁶² However, some authors

²⁵⁶ Drawbacks of microfinance include a credit-based poverty trap, over-indebtedness, and the crowding out of other anti-poverty interventions.

²⁵⁷ See, e.g., Buera et al., *supra* note 17.

²⁵⁸ Ahlin & Jiang, *supra* note 16, at 1.

²⁵⁹ *Id.* These authors sought to use the Occupational Choice model to examine these effects based on the idea that access to credit allows some people to start businesses who previously had to subsist or rely on wages. Thus, microfinance can potentially reduce subsistence payoffs and reduce long term inequality and poverty.

²⁶⁰ That is, entrepreneurs who then start fully fledged firms and access the formal financial system.

²⁶¹ Ahlin & Jiang, *supra* note 16.

²⁶² Buera et al., *supra* note 17.

have commented that micro-entrepreneurship is not part of the global economy, nor of national or international trade statistics.²⁶³ The implications of this have been described against the “*rising tide lifts all boats*” strategy of globalisation and the economic statistical influences of microfinance.²⁶⁴ However, research by Ahlin and Jiang does consider the importance, indeed, the critical nature of the graduation of microfinance borrowers to full-scale firms on the long-term economic effect of microfinance.²⁶⁵

An important consideration in micro-entrepreneurship is the heterogeneity of borrowers. This means that simply providing access to credit does not necessarily create entrepreneurs.²⁶⁶ Indeed, this is a logical consideration and needs to be remembered when resting the economic development dreams on the shoulders of microfinance.

The heterogeneity of borrower characteristics is also a subject of study in itself in that it affects the people who undertake microfinance and subsequently how the funds are used. A study published in the *International Journal of Economics and Finance* by Parvin, Rahman, and Jia²⁶⁷ examined the factors which influenced entrepreneurship of women in rural Bangladesh.²⁶⁸ Despite the qualitative data collection and other methodological considerations, the results of this study does provide some detail into the factors which influence female micro-entrepreneurship and should be considered. In particular, this study found that women participate

²⁶³ Arch, *supra* note 16.

²⁶⁴ *Id.*

²⁶⁵ Ahlin & Jiang, *supra* note 16. Despite these theoretical issues, most empirical works on the economic effect of microfinance have not considered the effect of micro-entrepreneurship occurring at a level too small to be included in cross-country statistics, and this provides a consideration when analysing the quality of empirical papers in this field.

²⁶⁶ Aggarwal et al., *supra* note 94.

²⁶⁷ Lovely Parvin et al., *Determinates of Women Micro-entrepreneurship Development: An Empirical Investigation in Rural Bangladesh*, 4 INT'L J. ECON. FIN. 254 (2012).

²⁶⁸ *Id.* These authors collected data from 248 entrepreneurs and 132 non-entrepreneurs regarding their personal attributes, family situation, and environment. The study used a sampling method which seems to entail using all the possible entrepreneurs in a particular village in rural northern Bangladesh and a convenience sample to identify non-entrepreneurs. An interview schedule was applied to each participant and it is presumed that the responses were coded to allow for quantitative statistical analysis. The authors used a probit model to explain the impact of these explanatory variables on the probability of doing micro-entrepreneurship, and the model seems sound given that it was also used by other authors such as Roodman and Morduch.

in micro-enterprises because they want freedom of work and an increase in social status.²⁶⁹ Importantly, the research found that families in financial hardship are more likely to undertake microfinance.²⁷⁰

An empirical paper on the impact of microfinance on entrepreneurship and social benefits has been undertaken by Banerjee, Duflo, Glennerster, and Kinnan and published as a working paper with the Bureau for Research and Economic Analysis of Development.²⁷¹ These authors found that the establishment of an MFI in a new market resulted in an increase in 50% of borrowers in that area, and access to the MFI was used to borrow, invest, and create and expand businesses.²⁷² Further, these authors found household differences in the effect of microfinance, and those with the propensity to start businesses reduced the consumption of food and temptation goods, whereas those with lower propensity to start businesses increased food consumption as a result of their access to microfinance.²⁷³ These authors comment that this household discrepancy means that the long-term effect of microfinance is difficult to assess because some households may actually get poorer, though they eat more, while others get richer, while eating less, as a result of access to credit.²⁷⁴ These authors also found that microfinance shows no effect on education, health, or female empowerment.²⁷⁵

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷¹ This key empirical paper provides experimental evidence from the implementation of randomised MFI establishment in certain “*bastis*,” or neighbourhoods, in Hyderabad. These researchers partnered with Spandana, a large and growing MFI which is primarily similar to the Grameen model of microfinance loans, but it does not provide business or financial literacy training. Spandana identified 120 areas and 2,800 households completed a baseline survey in 2005 before the randomised establishment of MFI branch’s in 2006–2007. The baseline survey, while not being implemented randomly, did allow the researchers to track the control and experimental groups for changes as a result of microfinance being made available. This experimental model, while not being perfect, does allow for widely generalized results on the effect of microfinance. Abhijit Banerjee et al., *The Miracle of Microfinance? Evidence from a Randomized Evaluation*, NBER Working Paper No. 18950, NAT’L BUREAU ECON. RES. (May 2013), available at <http://www.nber.org/papers/w18950>.

²⁷² *Id.*

²⁷³ *Id.*

²⁷⁴ *Id.*

²⁷⁵ *Id.*

3. Social Benefits of Microfinance

From a social perspective, microfinance has been relatively successful, with much of the previous research indicating an increase in empowerment of borrowers and increased access to finance, especially for female borrowers.²⁷⁶ Although the research confirming the qualitative success of microfinance is not unequivocal, varying research methods and countries may indicate that results are not directly comparable and this may explain the discrepancy. It is the social equality and fairness aspect of political goals which continue to motivate governments to support microfinance, both in and out of the developing world.²⁷⁷ Considering that the political goals are primarily social, it can be extended to conclude that the analysis of whether microfinance is a success or failure should be limited to social benefits. From this perspective, microfinance has achieved success benchmarks, in particular when related to social mobility.²⁷⁸

a. Social Mobility

The social mobility of people generally refers to the movement in social standing as a result of changes in income.²⁷⁹ It is a widely discussed goal of microfinance to increase social mobility of borrowers because of the resulting health and educational benefits from increases in income and social standing.²⁸⁰ An empirical study by Hamdani and Naeem found that microfinance results in an increase in social mobility and living standards as well as providing financial opportunities.²⁸¹ The results of this study allowed these authors to conclude that microfinance is a key strategy for quick economic revival, an increase in living standards, empowerment, and

²⁷⁶ See, e.g., Mayoux, *supra* note 221.

²⁷⁷ See, e.g., John M. Trussel & Linda M. Parsons, *Financial Reporting Factors Affecting Donations to Charitable Not-for-Profit Organizations*, 32 *ADVANCES IN ACCT.* 263 (2007).

²⁷⁸ See *supra* Part III.

²⁷⁹ Syed Muhammad Qasim Hamdani & Hummayoun Naeem, *The Impact of Microfinance on Social Mobility, an Empirical Evidence from Pakistan*, 3 *INTERDISC. J. CONTEMP. RES. BUS.* 81 (2012).

²⁸⁰ *Id.*

²⁸¹ *Id.* The sampling of the borrowers examined in the study was not reliably shown to be representatively applied the social mobility scale to 350 microfinance customers of three leading MFIs in Rawalpindi and Islamabad in Pakistan.

social mobility.²⁸² Although social mobility is a key desired result from microfinance, empirical studies focussing on this independent variable are limited and there is potential scope for future research on this aspect of microfinance social effects.

b. Intergenerational Effects

The effect of microfinance on intergenerational reductions in poverty are intuitive in that families with more successful businesses are more financially able to send their children to school, and higher education provides the children and subsequent generations with better potential long-term financial outcomes. However, this does not account for the potential that children provide a cheap source of labour for a growing family business. An influential study by Augsburg, De Haas, Harmgart, and Meghir as a working paper for the National Bureau of Economic Research has analysed exactly this paradox to determine the impact that microcredit has on intergenerational poverty reduction, child and teenage labour and education.²⁸³

The study examined the effect of microcredit on child and teenage labour and education in order to determine the intergenerational effects of microcredit.²⁸⁴ The key findings of this study are that microcredit results in lower education and a higher labour supply of teenagers to family

²⁸² *Id.*

²⁸³ Britta Augsburg et al., *The Impacts of Microcredit: Evidence from Bosnia and Herzegovina*, 18538 NAT'L BUREAU ECON. RES. (2012). Augsburg et al. used a Randomised Controlled Trial methodology to randomly provide credit to 1,198 borderline applicants previously refused microfinance in Bosnia and Herzegovina. This experimental design allowed the authors to isolate the direct effects of microfinance on the variables of interest as half of the participants received credit and half did not, but both groups were monitored over a 14 month period. However, the potential population sample of this study comprised only those borderline applicants who were rejected, so the sample may not be representative of microfinance in general. The selection of participants for this study was a critical component of the experimental methodology as they were able to identify participants who thought they had a viable business opportunity and were on the borderline of being accepted. However, as the participants were refused microcredit by the bank previously, demographic trends were found to be different than to the existing group of borrowers within the microcredit institution. In particular, the participants of the study were slightly poorer and more disadvantaged than regular borrowers. However, consistent interest rates were charged 22% compared with 21% to regular borrowers and the average loan was the equivalent of \$1,012 over an average maturity of 57 weeks.

²⁸⁴ *Id.*

businesses between 16 and 19 years old.²⁸⁵ These authors found that microcredit does not lead to an increase in profits or an increase in household income over the observation period. However, being provided with microcredit does increase business activity in that there are increases in business ownership and reductions in the purchase of temptation goods.²⁸⁶ The study also found evidence that the microcredit loans are too small to start or expand a business, in that borrowers either ran down savings²⁸⁷ or decreased consumption²⁸⁸ over the period to compensate. Although 77% of the borrowers offered collateral for the loans, the result of this was adverse selection as evidenced by erratic repayment by those who offered collateral.

The study by Augsburg et al. highlights that the intergenerational effects of microfinance may in fact be the contrary to those often promoted by microfinance advocates. Specifically, this research found that increases in parental wealth *do not* necessarily result in higher childhood education, especially for females, and that instead, this is effectively an intergenerational transfer of wealth from children to parents.²⁸⁹ There may alternatively be more efficient tools at alleviating long-term poverty. The authors propose a combination of microfinance and Conditional Cash Transfer (CCT) to overcome the effective competition between business activity and schooling which is currently underpinned by microcredit. However, these innovations cross the line between treating borrowers as valued members of the financial system and charity recipients with conditions for doing what external people impose as beneficial.

D. Financial Sustainability

There is a theoretical trade-off between MFI financial sustainability and financial access to the poor. Hence, for the purposes of this article, microfinance success includes MFIs which are financially self-sustainable. Financial self-sustainability is when MFIs are able to internally fund their

²⁸⁵ *Id.* This is because internal labour is cheap (potentially free compared to hired labour), therefore the borrowers choose to transfer utility from their children to themselves for business activity.

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.*

²⁸⁹ *Id.* This is the opposite of what microfinance is designed to achieve.

operations through revenue reliance on donations or low-interest loans from government. Financial sustainability can be described as an economic model of the relationship between the funding source, transaction costs, and profit with outreach to target borrowers. There is a theoretical balance between regulation and the sustainability of MFIs. This is because the regulation of MFIs has the potential to affect the sourcing of credit on international markets and the business operations such as product design.²⁹⁰ Financial sustainability is achieved if the MFI outreach and functioning occurs in isolation from the whims of donors or credit providers. Regulation can do this by allowing access to funding sources such as savings (because, generally, only banks can accept deposits),²⁹¹ international investment funds, and credit market access. With proper regulation and monitoring, these sources of capital are able to flow towards MFIs as well as equity partnerships.²⁹²

If MFIs are not financially stable or otherwise unable to access these sources of sustainable capital to lend to microfinance borrowers, they must primarily rely on other funding sources, either from NGO's or subsidised credit from governments. The result of this is that although the social benefits from microfinance may continue to be reached, the continuation of these benefits relies on a cycle of charitably motivated funding. Authors have found that although the microfinance industry is transforming, funding is not.²⁹³ A financial model which relies on donor funding when a self-sustaining model is available may put MFIs under unnecessary risk. This is because if MFIs are reliant on donor or subsidised funding and if there is a change in the financial stability or focus of their sponsors, MFIs may be left without funding.²⁹⁴ However, it is the legislation of MFIs which potentially influences whether they are regulated to a financially stable level where they can receive deposits and also whether international and credit market funding sources are available.

²⁹⁰ INT'L MONETARY FUND, *Rural and Microfinance Institutions: Regulatory and Supervisory Issues*, in FINANCIAL SECTOR ASSESSMENT: A HANDBOOK, 187 (2005), available at <https://www.imf.org/external/pubs/ft/fsa/eng/pdf/ch07.pdf>.

²⁹¹ Satta, *supra* note 42.

²⁹² Di Bella, *supra* note 50, at 32.

²⁹³ Al-Azzam et al., *supra* note 12, at 62.

²⁹⁴ Josephat Mboya Kiweu, *Relaxing Financing Constraint in the Microfinance Industry: Is Commercialization the Answer?*, 9 J. BUS. & ECON. RES. 87 (2011).

In determining the performance of microfinance institutions, authors have considered the trade-off between sustainability and outreach. Ferro Luzzi and Weber examined the measurement of MFI performance.²⁹⁵ The results of the analysis by Ferro Luzzi and Weber show that the efficient use of capital by small-scale entrepreneurs leads to potentially high returns and thus a willingness to pay relatively high interest rates.²⁹⁶ Based on their findings, these authors comment that in order for MFIs to complete the market they either focus on increasing outreach to the poor or on financial viability, and rarely both simultaneously. This article is particularly important for the current research because it provides a unique way of analysing MFI performance in a multi-dimensional context, something which has not been done in other papers.²⁹⁷ Despite these issues, the paper by Ferro Luzzi and Weber has provided some key results, such as illustrating the potential negative effect of interest rate ceilings and the time required to grant a first loan on financial performance of MFIs.²⁹⁸ This research effectively found that there are a number of key factors critical for MFI performance and borrower outreach, which are often at odds with each other. An implication of these results is that there needs to be operational efficiency of MFIs which includes the monitoring of loan officers and

²⁹⁵ Giovanni Ferro Luzzi & Sylvian Weber, *Measuring the Performance of Microfinance Institutions* (Centre de Recherche Appliquee en Gestion, Haute ecole de gestion de Geneve, Working Paper, 2006). These authors use data collected by the Graduate Institute of Development Studies of Geneva on 45 MFIs from 1999–2003, and utilised the particular variables of interest for the paper. In particular, the authors use loan size as a proxy for depth of outreach in that small average loan sizes reflect that MFIs reach the very poor. Further, the percentage of female borrowers is also a proxy for depth of outreach because loans to women are apparently more highly valued by society. In addition, the range of financial services provided by MFIs affects the scope of outreach. The number of loan officers per branch is deemed to affect both breadth and scope of outreach. These authors further theoretically extend that lending to groups reflects outreach to the poor. These factors of analysis can be combined to determine how oriented to serving the poor the MFI actually is. Using this data, these authors exploited the different dimensions of MFI performance to conduct factor analysis, which identifies separate influences on sustainability and outreach individually without requiring pre-determinants.

²⁹⁶ *Id.* at 15.

²⁹⁷ *Id.* at 15–16. However, while the results of the paper do provide an indication of the most important aspects of financial performance of MFIs, the effect of country-specific macroeconomic and institutional conditions caused the clusters, generated under cluster analysis, to be somewhat undefined. This, in combination with the methodological issues of factor analysis, in not being able to determine absolute effects, means that the results of this study are indicative of outreach and performance aspects but not statistically definitive.

²⁹⁸ *Id.* at 15.

potentially performance based bonuses or a similar system as supported by Jiwani.²⁹⁹

Empirical studies have built on the results found by Ferro Luzzi and Weber and focused specifically on the effect of regulation on MFI performance.³⁰⁰ A particularly prominent study on this topic has been published in *Applied Economics* by Hartarska and Nadolnyak.³⁰¹ This research found that the capital ratio affects financial performance.³⁰² That is to say that MFIs which are better capitalised have higher financial sustainability. Further, age and size also positively impact MFI sustainability, potentially because of the resulting impact on funding sources. Hartarska and Nadolnyak found that having access to more funding sources resulted in higher financial sustainability, while having access to more savings resulted in greater outreach as measured by the number of borrowers.³⁰³ The potential implication of this is that prudential regulation directly concerning MFIs³⁰⁴ has the ability to increase the amount of savings held by MFIs and this can affect outreach.³⁰⁵ Thus, there are indirect benefits of regulation in that increases in savings in MFIs results in greater outreach and access to credit.

Following the trend of the area of interest followed by Hartarska and Nadolnyak and Ferro Luzzi and Weber, a paper by Haq, Skully, and Pathan examines the cost efficiency of MFIs.³⁰⁶ Haq et al. found that although in

²⁹⁹ See, e.g., Jay Jiwani, *Sustainable Microfinance: The Impact of pay for performance on Key performance Indicators* (Apr. 27, 2007) (unpublished Ph.D. Dissertation, Argosy University—Chicago).

³⁰⁰ See Luzzi & Weber, *supra* note 295.

³⁰¹ Hartarska & Nadolnyak, *supra* note 190. These authors used panel data which allowed them to determine if fixed or random effects were the most appropriate methodological perspective. In examining the data for 114 MFIs in 62 countries, these authors found that MFIs are less leveraged than banks and yet 38% of MFIs do not collect savings to supplement the reduced access to capital from external sources.

³⁰² *Id.* at 1215 (examining performance as a function of bank-specific variables, macroeconomic conditions, institutions, and the regulatory framework).

³⁰³ *Id.* at 1220.

³⁰⁴ In terms of microfinance, prudential regulation refers to the licencing and regulation of formal MFIs for ongoing activities.

³⁰⁵ Outreach is a previously defined political goal from the preceding papers.

³⁰⁶ Mamiza Haq et al., *Efficiency of Microfinance Institutions: A Data Envelopment Analysis*, 17 *Asia-Pac. Fin. Markets* 63 (2010) (Using data from the Mix Market Exchange on 39 MFIs in Africa, Asia, and Latin America, these authors used a non-parametric Data Envelopment Analysis, a piece-wise linear combination that connects the best practice observations and forms a convex productions set of possibilities. This methodology is especially useful to apply to non-profit organisations where high

the short-term NGO-run MFIs were the most efficient, in the long-term it was possible for bank-MFIs to be the most efficient.³⁰⁷

Bauer and Gaskell developed two models to examine MFI cost efficiency and found that efficient MFIs have greater outreach³⁰⁸ and higher operational sustainability.³⁰⁹ Interestingly, these authors identified the Ethiopian Bank-MFI “*DECSP*” as the most technically efficient. It was found that NGO-MFIs have the highest overall mean efficiency, which indicates that the regulation affecting these institutions may be the most relatively supportive. In terms of operating efficiencies, it was found that cost efficient managers are better at managing customers and monitoring operational costs. Further, an implication for the size of MFIs is that efficiency is achieved from efficiently using resources, not simply from the scale of production. This is despite the fact that larger MFIs have greater performance. However, to the contrary, this result may also indicate that any attempt to regulate MFIs leads to inefficiency because NGO’s are usually outside of regulation.

Despite the study of the financial performance of MFIs being limited to the data voluntarily provided to such companies as Mix Market Exchange, a number of studies have empirically examined the relationship between financial sustainability and performance and outreach. A key empirical World Bank study by Cull, Demirgüç-Kunt, and Morduch systematically studied the financial performance and outreach of 124 MFIs in 49 countries.³¹⁰ These authors found that screening and monitoring in group lending overcomes the issues of moral hazard and asymmetric information.³¹¹ The evidence for this finding is that as the interest rate increases, there is a reduction in the portfolio quality in individual loans but not for group loans.

profit and low cost are not vital. The relevance of this technique for the analysis of the sample selected is that the researchers do not need price information and they can work with a small sample size.).

³⁰⁷ *Id.*

³⁰⁸ These are output-oriented MFIs.

³⁰⁹ These are input-oriented MFIs.

³¹⁰ Cull et al., *supra* note 203.

³¹¹ *Id.* at 5–6. These authors made a distinction between the three main type of MFIs (individual-based, solidarity group lenders, and village banks) and examined if profitability leads to lower outreach as a result of “*mission drift*,” which is deliberately serving the wealthier and more profitable clients. These authors commented on the trend towards individual loans in large MFIs such as the Grameen Bank in Bangladesh and BancoSol in Bolivia, as individual loans are assumed to be more flexible.

In a summary of the empirical research on microfinance, Hermes and Lensink examined the trade-off between financial performance and outreach.³¹² These authors discussed how joint lending reduces asymmetric information because it provides incentives to the group to screen, monitor, and enforce repayment.³¹³ This effectively reduces the agency costs of the lender. Given that the poor are excluded from the financial system because of the cost to the bank to screen, monitor, and enforce contracts, along with a lack of collateral, this provides the microfinance innovation.

In determining the performance of MFIs, the outreach³¹⁴ to borrowers is often used as a benchmark. This study determined that outreach equates to reaching more borrowers.³¹⁵ This benchmark in itself is problematic because a focus on quantity rather than quality is rarely a good strategy when the well-being of the poor is a documented outcome. The direct influences on outreach to borrowers have been studied by Hartarska and Nadolnyak in a paper which aims to determine the effect of regulation on MFI performance.³¹⁶

Nonetheless, this paper followed an empirical methodology and determined that MFIs with more funding sources have more savings, and that more savings deposits results in higher levels of outreach. Further, prudential regulation has been found to directly increase the savings held by MFIs. As an indirect conclusion, these authors also found that economic freedom and property rights security did not affect MFI sustainability but did increase outreach to borrowers. The results of this study indicate that outreach is an established goal of microfinance and that regulation has the ability to directly affect it via deposit rates.³¹⁷

Banks require capital in order to provide loans to borrowers, to finance operational costs, and fund expansion. The operations of MFIs are no

³¹² Hermes & Lensink, *supra* note 4, at F1.

³¹³ *Id.* at 2.

³¹⁴ For the purposes of this paper, outreach is defined as the number of borrowers reached by microfinance services.

³¹⁵ Hartarska & Nadolnyak, *supra* note 190, at 1212.

³¹⁶ *Id.* This study examined 114 MFIs from 62 countries using data from Mix Information Exchange. These authors determined performance as a function of bank specific variables, macroeconomic conditions, institutional design, and the regulatory framework. This particular study by Hartarska and Nadolnyak documented a variety of important results for the regulation of MFIs, discussed in subsequent sections of this paper.

³¹⁷ *Id.*

different in a general sense regarding the sources from which they obtain capital and at what cost.³¹⁸ Traditionally, MFIs have been financed by donor capital from NGO's and western governments.³¹⁹ However, there has also been a trend in recent decades for MFIs to obtain finance from private investors who purchase shares as investments or from domestic and international capital markets.³²⁰ The recent trend in changes in the sources of capital MFIs use is motivated by the increased consideration of MFI financial sustainability, as discussed in the previous Parts. The relationship between the regulation of MFIs and their performance as measured by financial sustainability and outreach is an area of research closely aligned with the topic of the current article. However, the current article is primarily concerned with considering how different approaches to microfinance regulation may be better suited to stimulating the initiative, considering the range of social and economic issues discussed up until this point. Thus, the following Part considers CSR and facilitative regulation as potential strategies for governments to consider.

V. CSR AND FACILITATIVE REGULATION

Microfinance has challenges to overcome in achieving political goals. There are financial sustainability barriers as well as cultural issues which may lead to the lower awareness and lower than expected microfinance economic success. It may be that regulation can assist in the promotion of MFIs in increasing credit access to the poor. If regulation may assist microfinance there are three main types of regulation to be discussed. The regulation may fall under self-regulation CSR, facilitative regulation, or direct regulation. The current and next Parts of this article will discuss regulation opportunities in the context of microfinance. These Parts aim to identify whether legislation can theoretically solve the market problems, which were identified previously in this article. These discussions will identify the different types of regulation in terms of a tiered approach to microfinance promotion in that the ideal first step is CSR. If CSR fails, facilitative legislation may be implemented. If facilitative legislation fails,

³¹⁸ See *supra* Parts III.A.1 and III.A.2.

³¹⁹ Di Bella, *supra* note 50, at 3.

³²⁰ Block, *supra* note 100, at 63–64.

direct legislation may be required. Thus, the three approaches to regulation work together to achieve the desired outcome, complementing each other to achieve political goals.

A. Corporate Social Responsibility

Corporate Social Responsibility (CSR) has potentially direct and strong impacts on microfinance promotion all over the world through such initiatives as “green finance” where banks in developed countries provide low interest loans directly to MFIs. CSR types of programs are supported by most large financial institutions and organisations all over the world with the aim of contributing to society as well as being profitable. This kind of program is sometimes referred to as the “triple bottom line,” where companies measure and report the social and environmental outcomes as well as financial. These programs are social initiatives designed by, financed, and implemented by organisations all over the world with the aim of increasing employee morale and reputation in the market.

Many CSR programs are employee driven, or act as an incentive when attracting employee talent in that people are more likely to work for an organisation which not only makes profit, but also supports some social objectives and programs.³²¹ Research is ambiguous regarding the relationship between CSR programs and financial performance with studies showing that either there is a relationship, is not, or it is unclear.³²²

In essence, CSR programs are self-regulation where institutions design programs to achieve political social and economic goals. In some developed and developing countries there is legislation which supports CSR programs, which can in turn benefit microfinance if that is the avenue of financial support. CSR programs can operate either in developed or developing countries. Further, CSR programs may entail green finance operated

³²¹ Ramin Gamerschlag et al., *Determinants of Voluntary CSR Disclosure: Empirical Evidence from Germany*, 5 REV. MANAGERIAL SCI. 234 (2010).

³²² See, e.g., Leonardo Becchetti, *Corporate Social Responsibility and Corporate Performance: Evidence from a Panel of U.S. Listed Companies* (Centre for Int'l Studies on Econ. Growth, Working Paper No. 78, Dec. 2005); JOSHUA D. MARGOLIS & JAMES P. WALSH, PEOPLE AND PROFITS? THE SEARCH FOR A LINK BETWEEN A COMPANY'S SOCIAL AND FINANCIAL PERFORMANCE (2001); Abigail McWilliams, Donald S. Siegel & Patrick M. Wright, *Corporate Social Responsibility: Strategic Implications*, 43 J. MGMT. STUD. 1 (2006).

directly by the institution or the funding of development programs or microfinance programs which indirectly achieve the individual CSR goals of the organisation. This is especially relevant considering that many CSR programs support microfinance.³²³ If MFIs are able to operate in a financially sustainable way, it is possible for CSR to contribute to support MFI expansionary programs or through knowledge transfers rather than simply donations.

1. Can Regulation Stimulate Microfinance via CSR?

The legislation of developed countries can stimulate or support CSR directly via taxation incentives. Given that a body of funds come from developed country CSR programs, the stimulation directed regulation here may have a wider social effect than the regulation of developing countries. In Australia, donations to registered charities are tax deductible, and with corporate tax rates fixed at 30% this effectively results in a 30% discount to corporations for donations.³²⁴ The inclusion of donations in the expenses, which can be claimed as tax deductible, allows CSR programs to justify the cost of their programs to budgetary deciders within each organisation. In order to directly stimulate microfinance via CSR programs, it may be possible for tax incentives or rebates to be higher for costs and knowledge transfers associated with microfinance. However, this strategy would need to be built on a foundation of studies on the efficiency of microfinance at achieving political goals, of which this study is not one. This study is concerned with the legal institutions which can promote financial inclusion through financially self-sustainable MFIs.

The legislation of developing countries can indirectly support CSR programs by strengthening the market conditions in which CSR funded initiatives operate and by reducing corruption.³²⁵ Arguably, environments which have a more effective use of resources and fewer concerns about corruption, may attract more consistent CSR program funding. In addition,

³²³ See generally *Microfinance*, ING, <http://www.ingforsomethingbetter.com/initiatives/microfinance>.

³²⁴ N.S.W. Dep't of Trade & Inv., *Corporate Tax Rates* (2013), <http://business.nsw.gov.au/invest-in-nsw/about-nsw/economic-and-business-climate/corporate-tax-rates>.

³²⁵ Di Bella, *supra* note 50, at n.16.

many international banks have subsidiaries in developing countries and legislation may be able to support these locally regulated and taxed organisations in achieving social objectives. The tax incentives for microfinance CSR programs, which are an opportunity, may also be effective in developing countries with financially independent subsidiaries.

2. Credit Database and Disclosure

There are a variety of initiatives which regulators can implement to promote microfinance. However, many are seen as being overly burdensome to implement or monitor. Some initiatives such as a credit database and disclosure regulation has the potential to promote microfinance in a “*softly, softly*” manner which does not have many potential disadvantages, but has many potential benefits. In an OECD working paper, Herd et al. analyse the financial reforms of India and develop recommendations for microfinance regulation to promote microfinance.³²⁶ The authors based an analysis on the law of microfinance in India with the aim of avoiding the consequences such as were seen in Andhra Pradesh in 2010 with interest rate caps introduced by the state parliament. The paper established the situation of microfinance in India in 2010, and theoretically discussed the effect of financial sector reforms on financial sector efficiency and the spill-over effects on the rest of the economy. In particular it was found that 13 out of 14 of India’s largest MFIs were regulated as non-bank financial companies and were not allowed to take deposits. The result of this is, understandably, that there is lower microfinance penetration.³²⁷

The legal analysis conducted by Herd et al. focussed on future Indian financial reforms.³²⁸ This paper suggested that the government can do things to reduce the risk of over-borrowing other than caps on interest rates, such as a credit database. Further, these authors suggested that personal bankruptcy laws be developed to complement the credit database. These two suggestions for regulation affect microfinance directly by supporting

³²⁶ Herd et al., *supra* note 75.

³²⁷ Hartarska & Nadolnyak, *supra* note 190, at n.2.

³²⁸ Herd et al., *supra* note 75, at 2.

borrowers and providing fewer transaction costs than other legislative reform in this area.

3. *Green Finance*

Operational challenges of microfinance rely on the sourcing of capital to on-lend to borrowers and fund business operations. One source of finance is through green finance, which are wholesale loans provided by large banks to MFIs. One example of green finance is ING's subsidiary, ING Vysya, and the Green Finance department which together provide more than €70 million in wholesale loans to MFIs in more than eight countries.³²⁹

Banks have incentives to do this kind of CSR program not only for marketing content in developed countries, but also because of tax incentives in many countries for charity expenses, as discussed previously. It is possible that the reputational benefits from green finance CSR programs are enough to stimulate MFIs without the need for direct regulation.

4. *Implications of CSR*

The key benefit of CSR microfinance programs is cost effectiveness in terms of allocating funds to MFIs without taking resources from the governments of developing countries, nor from NGO's. In essence, this is a Pareto improvement in the amount of funds available for microfinance in developing countries. However, it does, of course, bring further issues forward in the discussion of the "North-South" debate and whether Western consultants are indeed the best allocators of funds to MFIs. An additional benefit is that CSR programs allow direct MFI support which bypasses some avenues of domestic corruption which plagues many developing countries.³³⁰ Further, CSR microfinance initiatives are designed and implemented by organisations with teams of qualified and experienced

³²⁹ ING, ING Group Corporate Social Responsibility Report: Performance Report 2007, at 18, <http://www.ing.com/web/file?uuid-f825bd49-348a-48d0-843e-c8a7860185db&owner=b03bc017-e0db-4b5d-abbf-003b12934429&contentid=6465>.

³³⁰ See Eduardo Buscaglia, *On Best and Not So Good Practices for Addressing High-Level Corruption Worldwide: An Empirical Assessment*, INT'L HANDBOOK ON THE ECONOMICS OF CORRUPTION 453 (Susan Rose-Ackerman & Tina Soreide eds., 2d ed. 2011).

consultants who are able to use transferable skills to ensure operating efficiency in allocating the funds to each source. Those in developing countries may be capable of efficiently designing and implementing CSR programs, but using resources from developed countries means that the developing country resources are not diverted.

The imposition of microfinance charity externally through CSR programs has the potential to completely miss the target aims of microfinance. This is because it is not possible for executives in developed countries to be able to understand exactly what is needed in developing countries to stimulate microfinance and achieve the subsequent political goals.³³¹ Although CSR programs may consult with local operators and advisers, there may still be an air of the imposition of ethical ideas in a “we know what is best for you” colonial sense. In light of this disadvantage, it is understandable that CSR programs invest heavily in knowledge of their programs before allocating funds,³³² although the extent of this presents a trade-off between using capital which could otherwise be allocated to microfinance and ensuring that the money serves the desired goals. An example of this is the failure to address both capital constraints and human capital constraints. Entrepreneurship development programs have often failed to create entrepreneurs out of the poor they give to, when inadequate training results in the “income generating assets,” such as egg-laying chickens becoming this evening’s dinner. In light of this trend of disadvantages, the impact of CSR programs may be less than what would otherwise be expected. However, the Pareto benefits from CSR supporting legislation in developed and developing countries provides adequate motivations for support.

B. Facilitative Regulation

Thus, facilitative legislation such as tax concessions can stimulate organisations to self-regulate through CSR programs to benefit microfinance. However, in the case of microfinance, there are advantages

³³¹ Tammy D. Allen et al., *The Mentor’s Perspective: A Qualitative Inquiry and Future Research Agenda*, 51 J. VOCATIONAL BEHAVIOR 70 (1997).

³³² See Philip Burnard, *A Method of Analysing Interview Transcripts in Qualitative Research*, 11 NURSE EDUC. TODAY 111 (1994).

and disadvantages of each type of regulation, and these indicate that the implementation of regulation may need to be across the different types, and tailored to each specific country.

1. State Guarantee

State guarantees of deposits are a technique recently used in many developed countries to prevent bank runs during the GFC. State guarantees of deposits have the potential to increase the financial sustainability of MFIs by providing for a source of capital which comes from the local population of MFI branches. State guarantees of deposits move the reliance of trust from the depositor on the MFI to the government, which may have the result of increasing deposits. State guarantees are also applicable to microfinance loans in order to reduce the risk to banks for providing microfinance loans. The state guarantee of microfinance loans is effectively a replacement for collateral. Although there are already repayments of 99% on microfinance loans,³³³ perceived risk of microfinance loans by banks may not equate to this reality. In theory, state guarantees of microfinance loan amounts provide incentives for banks to lend money to microfinance borrowers so long as transaction costs can be covered, as the risk of default is not borne by the bank, but by the government instead. However, at this stage almost all microfinance is provided by specialised MFIs.

In practice, this theory does not account for the high transaction costs associated with providing and monitoring each microfinance loan. An important disadvantage of state guarantees are potential mass defaults on loans which can destabilise the credibility of microfinance, and also the financial sustainability of MFIs while they apply for their losses to be recouped from the state. In effect, the state guarantees of microfinance loans may potentially result in harm to the microfinance sector. As with all potential results, this depends on the specific country in question and especially the loan culture and levels of trust and cultural capital.

Thus, the state guarantee of microsavings and microfinance loans is unlikely to have large negative consequences on the social and developmental outcomes of the poor, although it is unlikely in itself to have

³³³ Di Bella, *supra* note 50, at 32.

a large impact on the success of microfinance, and the sustainability of MFIs.

2. Innovation

The potential for microfinance to be developed within a country by building on existing infrastructure has promising outcomes across the world, especially in the case of building on existing mobile phone uptake. In an OECD working paper, Herd et al. examined the financial reform in India and considered the various ways mobile phones can be utilised in increasing financial inclusion.³³⁴ These authors discuss the additive model where there is a new interface for existing customers, and the transformational model where the telecommunications company provides a money transfer system through their own network, with local agents who give and receive cash. The additive model is the path that has been chosen by the RBI for India. However, these authors suggest that the government can facilitate this technological innovation by reducing the “*Know Your Client*” regulation for banking services under a certain account balance. This is especially prudent considering that India does not have a national requirement for identity cards. The paper supports the potential impact of this legislative change by illustrating the penetration of mobile phone based financial services in Kenya, a country which has bank density of one third that of India and yet financial system inclusion much higher proportionally, also considering the relatively similar mobile phone penetration rates of the two countries. The potential scope for microfinance penetration through innovation is large and requires complementary legislation to achieve the goal.

The OECD working paper by Herd et al., while focussing on potential financial reform for India, suggests that the model of financial system inclusion via mobile phones be developed.³³⁵ In order for financial services to be provided via mobile technology, regulation needs to support less stringent requirements to establish a financial relationship. For example, regulation changes in Pakistan to mobile banking rules have resulted in

³³⁴ Herd et al., *supra* note 75, at 24.

³³⁵ *Id.*

large increases in financial system access.³³⁶ The potential scope for microfinance penetration through innovation is large and requires complementary legislation to achieve the goal.

3. Support of Microsavings Products by MFIs

Microfinance is a financial innovation which has resulted in creative thinking to develop strategies for increasing financial inclusion to the poor. Authors have discussed that if the poor can borrow their way out of poverty, they can just as surely save their way out of it.³³⁷ Microsavings theoretically does all the things that credit does, but without the interest rate and inflexible loan amounts and repayment schedules. Specifically, savings can allow for precautionary savings and provide an amount for starting a business.³³⁸ Further, savings puts the poor under no burden of debt and is not a resources diversion from other avenues of donor support.³³⁹ With no other options available, it is better than cash hidden under a mattress.

It is possible for the government to provide regulation which supports the establishment and sustainability of MFIs. This potential facilitative regulation option would theoretically work alongside a government guarantee of microdeposits. This is because people are already somewhat untrusting of MFIs, so it can be imagined that trusting small organisations with savings is even less likely than the lending of money.³⁴⁰ A government guarantee can potentially increase the level of trust and the use of microsavings, but this also creates a potential moral hazard situation. The potential market for regulated and state guaranteed microsavings institutions is reinforced by the current use of savings accounts by the poor which are suboptimal in that they are costly and present some risk to the depositor. Many savings accounts currently used and active in Africa have no interest and charge a withdrawal fee, yet are still in use.³⁴¹

³³⁶ STATE BANK OF PAKISTAN, *supra* note 132, at 2.

³³⁷ Aggarwal et al., *supra* note 94, at 3.

³³⁸ *Id.* at 18.

³³⁹ *Id.*

³⁴⁰ *Id.* at 23.

³⁴¹ *Id.* at 19.

*“If the poor can borrow their way out of poverty then they can equally well save their way out of it.”*³⁴² In a World Bank working paper, Aggarwal et al. present a line of analysis and argument for the support of microsavings programs in sub-Saharan Africa. These authors found that trust is critical for financial behaviour and that it is closely related to the problem of corrupt institutions. These authors also found that if there is low trust in the country, people do not borrow and they definitely do not deposit. Thus, the regulatory initiatives to provide support for savings may need to be much more encompassing of the whole financial system and country in general. That is, regulation which can promote microfinance may need to address the regulation of MFIs, however, the regulation which can promote savings may need to address systemic corruption and financial system security, among other things.

However, despite these challenges, these authors develop theoretical arguments for microsavings as programs with high potential impact because savings do all the things that debt should do, but without the burden of debt or resource diversion. Further, Aggarwal et al. found that there is a large potential scope for microsavings in that people already use various savings methods which are expensive. These savings methods are costly because they often give no interest, charge a withdrawal fee, and are risky.³⁴³ Thus, innovation in microsavings can provide the poor with accounts to which they have access and which are dependable. The issue of microsavings and the support of such innovations are key to the consideration of microfinance because of the previously discussed potential role of savings in financially self-sustainable MFIs.

4. Implications of Facilitative Regulation

The main benefit of facilitative legislation such as tax concessions and state guarantees is that the overall cost to the government is small compared to the potential benefit from microfinance and other development initiatives. Indeed, tax concessions for charity spending or for the provision of green finance may result in some lost tax revenue. There are, however,

³⁴² *Id.* at 17 (emphasis added).

³⁴³ *See id.* at 19.

limited actual expenditures, which means the avenues for corruption are fewer than with cost-bearing initiatives.³⁴⁴ In addition, facilitative regulation may potentially allow the diversification of financial services provided by MFIs.

Facilitative legislation provides incentives for large financial institutions to use their funds for supporting development and microfinance initiatives in developing countries. However, this legislation does not take any positive action towards specifically achieving the political goals discussed. Further, the actual cost of facilitative legislation is difficult to quantify because of the problem in isolating CSR investment, which is affected directly as a result of the tax concessions rather than through employee demands to management or a source for marketing content. In this way, the measurability issues of facilitative legislation mean that concrete discussions and empirical research about which facilitative legislation is most effective at stimulating microfinance are difficult to achieve.

Another key disadvantage is that facilitative regulation provides incentives for funds to be invested in philanthropic causes but not into the particularly effective avenues for development over others. The result of this is that funds may be balanced between avenues such as microfinance with historical empowerment benefits, and other avenues which result in lower benefit to the developing country. Further, in the event of a large economic shock with state guarantees of microsavings and microloans, an already under-resourced government may be required to divert resources to MFIs, banks, and borrowers, rather than the chronic poor who are outside the financial system and are in more absolute need of immediate support during such crises.

A key disadvantage of state guarantees of loans and deposits is that a large potential moral hazard may be created.³⁴⁵ That is, MFIs and banks may provide microfinance to those they know will not repay in order to collect the interest until they recoup the loan balance from the government. The costs and administrative burden of receiving the lost loan balance after

³⁴⁴ Charles De Matos Ala, *Fighting Corruption in Developing Countries: Strategies and Analysis*, 42 LAB. CAPITAL & SOC'Y 196, 196–98 (2009).

³⁴⁵ Jorg Guido Hulsmann, *The Political Economy of Moral Hazard*, 1 POLITICKA EKONOMIE 35, 35 (2006) (Czech).

default of a microfinance borrower from the government may in fact outweigh the loan balance that will be returned, and this may create further problems than the actual incentives provided by this legislation.

This Part has discussed CSR and facilitative law approaches which may facilitate microfinance to achieve established political goals. It can be seen that although CSR and soft law can potentially achieve the established goals, the systems are not perfect, and a combination of approaches is required. Thus, if soft law is not sufficient in all situations to achieve the goals of microfinance, it may be that direct regulation provides the framework required, and this will be discussed in the next Part.

VI. DIRECT REGULATION

Microfinance programs of CSR initiatives which are stimulated by facilitative legislation may not be enough to achieve the political goals which microfinance seeks to accomplish. If this is the case, direct regulation may be required. Direct regulation includes potential initiatives such as creating a maximum chargeable interest rate to microfinance borrowers or a minimum percentage of loans to microfinance out of the total loan portfolio for banks. Other options include the creation and management of government-owned MFIs. Direct regulation is a potential way to stimulate microfinance, however, some direct legislation can result in a regulatory failure by providing incentives which impact the distribution of resources in a manner which would not occur in an unregulated market.

A. Why Is There Microfinance Law?

Microfinance law has been implemented, as opposed to allowing MFIs to generally fall under banking law, in order to support the political goals of credit availability and distribution. However, the development of specific MFI law depends on each country and there is as yet no international framework from which developing countries can design their own regulations.³⁴⁶ Although, in essence, MFIs provide the same services as banks but on a smaller scale, the motivation behind the provision of these

³⁴⁶ Satta, *supra* note 42, at 69.

services results in different risks to customers and different societal effects.³⁴⁷ Thus, the law which regulates a profit seeking bank must surely be different to the law regulating a non-profit MFI with socioeconomic objectives.

It is logical that financial institutions which provide different products should be regulated differently. The fact that the objectives of microfinance are around credit availability to the poor and subsequent socioeconomic benefits, operational structures would naturally reflect this. In comparison, the profit motivated products and services of traditional banks would indeed be reflected by their operation. Although both entities may provide loans, insurance, pensions, and savings products, the motivation behind the operations and the subsequent effect on society require a different regulatory framework. Authors have commented that because of the scale of operations and products affected, the collapse of a single MFI is unlikely to have large consequences in an individual country.³⁴⁸ However, there are potentially life-changing effects on individual members of the poorest in society if they were to lose their microsavings. Thus, regulation is especially important for situations where the poor can potentially be worse off. This does not mean that no regulation at all is needed, it simply highlights that different regulation is necessary if the socioeconomic goals of microfinance are to be achieved.

The regulation of MFIs often covers only some of the products offered, such as deposits, and not others, such as loans.³⁴⁹ The fact that law generally covers deposits is a reflection of the consumer protection goals of governments, and indeed, banking regulations are present in all countries in some form or another. These laws generally attempt to ensure the financial stability of deposit taking institutions. The provision of small loans and the safeguarding of small deposits are two key services which distinguish microfinance from regular banking and thus cannot, or at least should not, be considered in the same way.

The analysis of the development of microfinance law from a market failure perspective is that microfinance has in many ways evolved to changing market conditions, and evolved in a way which bypassed

³⁴⁷ Di Bella, *supra* note 50, at 25–26.

³⁴⁸ Satta, *supra* note 42, at 71.

³⁴⁹ *Id.*

traditional banking regulations. The village based savings and credit groups were organised informally all over the world until the introduction of microfinance as we know it.³⁵⁰ Thus, microfinance was not established by law and did not rely on law to create the industry. However, MFI regulation has the potential to increase the size of the industry, rural outreach, operating efficiency, and access to external funding.³⁵¹

B. How Does Microfinance Regulation Promote Microfinance?

MFI regulation in theory seeks to support the socioeconomic objectives for which microfinance has been designed to achieve. The formal financial sector finds poor people theoretically unprofitable because of the reasons discussed in the first and second Parts. Further, MFIs are able to operate from a smaller cost base and the development of the sector has been a result of internal growth, which did not require the stimulation from regulation.³⁵² Authors have stated that, in a general sense, the regulation of MFIs strengthens their financial stability and sustainability, which allows for more capital to be able to be provided to small and medium sized enterprises.³⁵³ Thus, the research tends to indicate that formal MFI regulation does help to achieve the political goal of credit availability.

Specific MFI regulation seeks to protect the financial system, protect depositors and to allow MFI financial sustainability which will in turn allow for credit availability to SME's and low income people.³⁵⁴ In the case of Tanzania, Satta found that the regulatory guidelines in 2004 over banks restricted them from providing microfinance services because of limits on unsecured lending and investment in fixed assets. This author found that no Tanzanian MFIs had moved to being regulated because of the restrictive legislation framework. These results indicate that it is not only that regulation itself may have an effect, but that specific provisions within the regulation are also critical for increasing financial inclusion for the poor.

³⁵⁰ Aiden Hollis, *Women and Micro-Credit in History: Gender in the Irish Loan Funds*, in *WOMEN AND CREDIT: RESEARCHING THE PAST, REFIGURING THE FUTURE* 73, 75 (Beverly Lemire, Ruth Pearson & Gail Campbell eds., 2001).

³⁵¹ Satta, *supra* note 42, at 65.

³⁵² Di Bella, *supra* note 50, at 8.

³⁵³ Buera et al., *supra* note 17, at 8.

³⁵⁴ Satta, *supra* note 42, at 71.

The findings by Satta suggested that non-deposit taking MFIs should have non-prudential regulation only.³⁵⁵ Non-prudential regulation covers such requirements as publishing annual reports, risk management strategies, and the board taking ultimate responsibility and accountability. However, as indicated by the research of MIX, the ability to take deposits may be critical for MFI sustainability, a result which could ensure the long-term increase in credit availability to the poor without reliance on NGO and subsidised funding.³⁵⁶

Regulation has the potential to promote microfinance by allowing access to funding either from microsavings or from international capital markets. These avenues of capital contribute to microfinance sustainability by reducing the reliability on donor funds. Greater financial sustainability, in theory, may increase credit access to the microfinance target market, who are costly to service because of the demographic reasons discussed in the second Part of this article.

C. How are MFIs Shaped by Microfinance Law?

The main challenge of policy makers has been to develop a regulatory structure which allows MFIs to provide reliable sources of finance for the growth of small firms and smoothing of consumption expenses.³⁵⁷ The main effect of microfinance law on the functioning of MFIs is that it can potentially address the main problem which MFIs face: the reliance on donor capital.³⁵⁸ As covered in the previous Part of this article, microfinance generally achieves the social goals politically defined within developing countries.

In the case of Tanzania it can be seen that the provision of microfinance to poor people is hampered by regulation which does not allow regular banks to provide microfinance.³⁵⁹ In Tanzania the regulation is so restrictive of microfinance provision that for regulated banks to offer

³⁵⁵ *Id.*

³⁵⁶ Changing Lives for the Better, Microfinance Information Exchange, http://www.mixmarket.org/sites/default/files/medialibrary/20501/1061/Microfinance_Article.doc (last visited Oct. 18, 2014).

³⁵⁷ Satta, *supra* note 42, at 67.

³⁵⁸ Durrani et al., *supra* note 122, at 142.

³⁵⁹ Satta, *supra* note 42, at 67.

microfinance they must create a separate entity which is unregulated.³⁶⁰ The regulation in Tanzania does this with the motivation of protecting the financial system, however the results of this are restrictions on loans, which are unsecured and loans which are not specifically for fixed assets, which characterise microfinance loans.³⁶¹ Authors have indicated that lower MFI competition and innovation can result in higher interest rates charged to borrowers.³⁶² It can be argued that limiting the provision of microfinance by the traditional financial system can affect MFIs in a wide variety of quantitative and qualitative ways, with mostly negative consequences for the poor.

Government initiatives to promote microfinance can potentially take the form of specific regulations or legal institutional policies, or a broad blanket approach to strengthening the legal framework in general. The suggestions from the literature on how governments can promote microfinance generally fall into these two categories. Works by the IMF have highlighted the adverse consequences of regulation, not only in terms of its costliness, but also in terms of potential regulatory failure.³⁶³ Various authors have concluded empirical studies by suggesting that rather than governments focusing on individual pieces of legislation, that rather the legal framework as a whole is strengthened.³⁶⁴ It has been stated that the strengthening of the legal framework entails generalising credit bureaus, increasing corporate governance, and financial reporting.³⁶⁵ However, broad recommendations such as these provide governments of developing countries with little direct instruction. Further, recommendations to strengthen legal frameworks and infrastructure may in themselves initiate a regulatory advice failure in that the task becomes so hard rather than implementing one particular regulation that governments choose to do nothing instead. There are clearly combinations of approaches required to promote microfinance in developing countries. The interrelationship between microfinance and general economic and social conditions is one

³⁶⁰ *Id.* at 71–72.

³⁶¹ *Id.* at 69.

³⁶² *Id.* at 66.

³⁶³ Di Bella, *supra* note 50, at 32–33.

³⁶⁴ *Id.* at 33.

³⁶⁵ *Id.*

which cannot be unravelled and as such potential initiatives need to consider both broad-based recommendations at a government level as well as particular regulations which can be implemented.

D. Legislation

Legislators have the power to control social outcomes, both for the good and for the bad. The legislator has control over implementing specific interventions in order to support the achievement of the socioeconomic goals which microfinance is designed to achieve. However, despite socially motivated intentions, interventions may have adverse effects. This section discusses actions by the legislator which are designed to support social and economic political goals, and the theoretical and practical consequences of these interventions. In particular, interest rate ceilings, loan portfolio proportions, and state guarantees are presented as potential direct regulation initiatives.

1. Interest Rate Ceilings

The charging of interest on loans is an ethical issue whose continued debate can be traced to biblical and Qur'an eras of literature.³⁶⁶ Apparently, the charging of interest, or making money from money, is forbidden by certain religious texts because it exploits those who are in need of finance by those who have available capital.³⁶⁷ Many of these texts state that the rich should lend to those who need capital with no interest costs.³⁶⁸ Modern financial planning and wealth creation strategies are based on a foundation of making money from money, showing the development of these rules in modern society. Although the majority of the law and economics literature is theoretically against interest rate ceilings, or "usury," governmental restrictions on the charging of interest have been present across modern

³⁶⁶ Norman Jones, *Usury*, EH.NET (Feb. 10, 2008), <http://eh.net/encyclopedia/usury/>.

³⁶⁷ *Id.*

³⁶⁸ *Id.*

civilisations for most of recorded history,³⁶⁹ and continue today in selected pockets of the world.³⁷⁰

Authors have found that even in theory the positive benefit of interest rate ceilings is balanced by the disadvantages to mean that there may even be overall negative effects. In particular, usury laws may reduce credit availability for the poor while benefiting the rich through lower interest rates on loans and less competition from new businesses entering their market.³⁷¹ These authors have found that each one percentage *reduction in interest rate limits* can lead to 4–6% less economic growth in the decade following.³⁷² Thus, interest rate ceilings not only inhibit economic growth, but on the other hand, may also protect the poor from unnecessary financial exploitation. Interest rate ceilings, thus, may have good motivations, but the practical effect may be the opposite of those intended, in that in the long term the poor are not protected from exploitation from interest rate caps.

When considering the effect of interest rate caps, it may also be relevant to consider the reason for high interest rates in the first place. There is not a clear theoretical understanding of why high interest rates on microfinance loans are so pervasive, yet differ widely between countries. On the one hand, uncollateralised loans to the marginalised in society considerably require compensation for the higher level of risk and costs in providing the loan. However, on the other hand, microfinance has been designed in a way so that for both individual and group contracts, reliable borrowers are selected by the community and have social pressure to repay the loan on time. This design, in theory, eliminates the risk and costs, because they are outsourced to the community. Yet, high interest rates prevail.³⁷³ There are two prominent possibilities for the high interest rates: a lack of competition which is a market failure given the unregulated nature of most MFIs,³⁷⁴ or MFI inefficiency. Theoretically, regulation and

³⁶⁹ *Id.*

³⁷⁰ Herd et al., *supra* note 75, at 8–9.

³⁷¹ Efraim Benmelech & Tobias J. Moskowitz, *The Political Economy of Financial Regulation: Evidence from U.S. State Usury Laws in the 19th Century*, 65 J. FIN. 1029, 1033 (2010).

³⁷² *Id.* at 1048 (The authors state that a 1% increase in the maximum legal interest rate leads to a 4%–6% economic growth over the next decade. The inverse is assumed to be true here.).

³⁷³ Di Bella, *supra* note 50, at 32–33; Mayer, *supra* note 24, at 808–09.

³⁷⁴ Arch, *supra* note 16, at 237.

institutions can address these underlying causes more effectively than can interest rate caps.³⁷⁵

A key disadvantage of usury laws is that financial innovation, as seen in Islamic microfinance to avoid *riba*, is easily able to overcome the issue of interest rates and instead use profit sharing, investment, or fee models which result in a similar benefit to the bank.³⁷⁶ Thus, in order to overcome this type of circumventing of specific laws, the supervisory body would need to document and monitor microfinance products to ensure these particular methods have not been employed. In developing countries with weak institutions, corruption, and scantily resourced supervisory bodies, this method is arguably fraught with risk.

Theoretically speaking, interest rate ceilings are designed to protect the poor from profiteering of loan sharks, payday lenders, and unscrupulous microfinance providers who seek to profit over and above the cost of providing the loans. This is understandable in environments where microfinance borrowers pay above 30% interest while regular borrowers pay below 10%.³⁷⁷ However, authors have found that governments wishing to reduce the interest rates payable on microfinance loans are better occupied with creating economic environments where MFIs can innovate and operate efficiently, such as by investing in telecommunications, roads, and education.³⁷⁸ Further, authors have suggested that rather than legislating interest rate ceilings and repayment schedules it is more prudent to do things to reduce the risk of over-borrowing such as a credit database and personal bankruptcy laws which complement credit disclosure.³⁷⁹ In practice capping interest rates can result in less credit availability, a clear failure of the legislation.

Particular aspects of microfinance are especially relevant for law and economics discussions on the topic. One particular aspect of relevance is the determination and charging of interest on microfinance loans. In an IMF

³⁷⁵ Cf. Mayer, *supra* note 24, at 825–27.

³⁷⁶ Abdul Rahim Abdul Rahman, *Islamic Microfinance: An Ethical Alternative to Poverty Alleviation*, 26 HUMANOMICS 284, 287, 291 (2010).

³⁷⁷ Di Bella, *supra* note 50, at 14.

³⁷⁸ *Id.* at 26–27.

³⁷⁹ Herd et al., *supra* note 75.

working paper, Di Bella examined the effect of the GFC on microfinance with a particular focus on the impact on interest rates.³⁸⁰

The results of the study by Di Bella, which are of most interest to this Part, are related to interest rate determinants.³⁸¹ This issue gained prominence in the GFC, along with the profits of MFIs, which were supposed to exist to serve the poor. The author of this paper goes into detail justifying the various reasons for the interest rates charged by MFIs being above those charged by commercial banks. This paper states that inappropriate regulatory caps on interest rates likely result in the withdrawal of MFI funding, reduced MFI scale, increased loan sizes, and increases in effective interest rates for the poor as there will be a shift towards TMLs, who charge higher interest rates than MFIs. This paper goes on to suggest that the most efficient methods to reduce interest rates charged on microfinance loans are: increasing infrastructure, innovating MFI practices, strengthening the legal framework, and increasing competition between MFIs.

2. *Minimum Percentage of Loans to Microfinance Clients*

In developing countries, there are already established financial institutions providing targeted financial products to the middle and upper classes. Rather than restricting the behaviour of MFIs, regulators have the potential to force existing banks to provide microfinance, whether it is directly or through subsidiaries. Theoretically, legislation is able to guarantee and require a certain percentage of retail capital, e.g. 20%, is allocated to microfinance borrowers, ensuring the mobilisation of bank assets to increase credit availability to the poor.

³⁸⁰ Di Bella, *supra* note 50. Di Bella empirically examined the determinants of lending rates using data from the Microfinance Information Exchange from 1995–2009 provided by 1774 MFIs in 107 countries. Of the available data, the study of interest sampled 353 MFIs who had available data for seven consecutive years from 1998–2009 and three years of data from 2007–2009 and other selection criteria to minimise survivorship bias. Di Bella grouped the MFIs based on region, institution type, legal status, purpose, and age. This paper examined variables of MFI performance, global and domestic market risk, and lending rate determination. Standard robustness checks seem to have been performed on the analyses to ensure validity of the results.

³⁸¹ *Id.* at 24.

In theory, this idea harnesses the existing success of financial institutions and their established channels of distribution and funding to increase the scope of credit access. Banks are already regulated and have established access to international credit markets and overnight lending agreements with other domestic banks, and this leads to operating efficiencies. However, forcing banks to provide products which previously brought no profit to them may lead to operations which satisfy the minimum requirements of the regulation and nothing more. This direct regulation strategy relies heavily on the definition of microfinance. For example, if microfinance is simply loans below \$1,000, it can be imagined that banks provide a set percentage of loans very close to that figure, rather than seek “real” microfinance clients, being those just above the poverty line.

There are problems with the incentives to banks and to borrowers to engage in microfinance.³⁸² In order to overcome these incentive problems, direct regulation provides a possible solution. These legislation options accompany and facilitate market functioning. However, as discussed, there are potential disadvantages of direct regulation, which means that it is realistically a last resort if CSR and facilitative regulation have not, over time, achieved the political goals which microfinance can meet. Direct microfinance regulation can potentially address the market issues of credit access not being available to the poor. However, while an increase in credit access may be achievable through a minimum percentage of capital allocated to microfinance and interest rate ceilings, it is not without potential adverse consequences that these initiatives are employed.

3. Tiered Regulatory Structure

The consideration for how MFIs should be regulated rests on a framework of understanding the different risks faced and posed by MFIs with different operating functions. It is intuitive that MFIs which do not receive deposits pose a much lower risk to the financial stability and well-being of the poor than MFIs which also receive deposits. This is because a loan provider which collapses does not necessarily take the life savings of

³⁸² Besley & Coate, *supra* note 110, at 2.

the poor with it, whereas a deposit taker may. In developing a series of recommendations for MFI regulation in Tanzania, Satta considered non-deposit taking MFIs and recommended that they employ internal rules for board governance and auditing, rather than imposing stringent requirements to ensure financial stability as the law would a deposit-taking MFI.³⁸³

This concept of treating different MFIs differently is key to the analysis of the sector from a law and economics perspective. The development of MFIs to complete the financial markets clearly illustrates the way MFIs differ from traditional banks. MFIs developed the way they did because banks were not able to provide access to credit for the poor. Thus, MFIs have different operations and purposes than banks, and should be treated differently. Further, MFIs differ between themselves and the regulation of all MFIs should not take the same form. The regulation of non-deposit taking MFIs should therefore reflect the operations and potential risks to society.

In the event that CSR and facilitative regulation are not enough to promote microfinance, direct regulation initiatives may be implemented. By legislating for the promotion of microfinance the positive intentions of the legislator may not be enough to ensure effectiveness. In the case of interest rate ceilings, it may be that the result is actually less microfinance outreach to target customers and more microfinance provided to the more profitable middle classes. However, there is the potential for direct regulation to positively affect microfinance in theory. For example, legislating for all loan providing institutions to provide a minimum amount of microfinance loans may stimulate innovation in the microfinance sector and encourage efficiencies of scale by building on already existing expertise in the traditional financial market.

VII. CONCLUSION

The current article has analysed the literature and legal institutions in order to attribute the development of microfinance to the legal framework, bureaucracy, and social support. It has been found that whether the legislation can support the goals that microfinance aims to achieve depends

³⁸³ Satta, *supra* note 42, at 72.

on the situations in the country, the benchmarks by which success is measured, and a variety of other market and cultural influencing factors.

Microfinance is an avenue for capital which may support the socioeconomic outcomes of the poor. Given that legislators support microfinance in their particular jurisdictions, they are then able to formulate regulatory responses to facilitate microfinance. At the theoretical extreme, governments may provide the capital themselves directly to the poor through state run programs. This is in many ways, what is happening in India, with state-run MFIs and interest rate ceilings in some regions. At the other extreme, governments may simply legislate in a way which facilitates microfinance through not restricting their operation and allowing market forces and NGO interventions to promote microfinance. A middle ground in this theoretical discussion may be that the government provides guarantees for the microfinance loans and savings accounts for the poor. However, the middle ground option does not account for the high transaction costs associated with providing and monitoring each loan by MFIs, and this may mean that the scheme does not have the desired effects.

The trade-off between sustainability and providing credit access is that the target market of microfinance brings very high transaction costs because of the likelihood of borrowers being illiterate, in extreme poverty, and geographically dispersed. Thus, although MFIs may be sustainable by serving the poor and middle classes, it is the chronic and rural poor who are the theoretical target market and require the most access to credit.³⁸⁴ Hence, it needs to be considered how important the sustainability of MFIs are considering that increased financial sustainability may be associated with lower outreach to the target market of microfinance.

Part V of this article presented potential soft law and CSR outcomes to the development of microfinance. It was found that if the right conditions are met, CSR supports microfinance in achieving socioeconomic goals, however it will not be sufficient. Thus, this section determined that facilitative legislation may be the appropriate default option for microfinance regulation. In conjunction with CSR, facilitative regulation may complement to provide incentives to banks and borrowers which increase the use of microfinance.

³⁸⁴ Di Bella, *supra* note 50, at 25.

Part VI of this article presented the direct regulation methods by which microfinance can be supported. The avenues for direct regulation indicated that restricting normal market functioning with regulation, regardless of the good intentions, may have the reverse effects unless designed with care. It was discussed in a theoretical manner that legislated interest rate ceilings may have results which restrict the amount of credit available to the poor, an outcome which is the opposite of the goals of the legislation. However, some regulation such as a set amount of loans from each bank going towards microfinance loans, or the government guarantee of microfinance loans may actually support innovation by banks and distribution of credit availability to the poor.

The first step of government intervention via regulation into the microfinance market is CSR. If the conditions required for CSR to be sufficient in supporting microfinance are absent, facilitative legislation is the next step of the regulator. Subsequently, if the conditions required for facilitative legislation are not sufficient to promote microfinance to a level to achieve socioeconomic goals then direct legislation may be required to achieve the outcomes which microfinance is designed to support. This procedure of regulatory design can be seen in Figure 1.

Figure 1. The Types of Intervention to Support Microfinance.



The law and economics of microfinance has indicated that there are many theoretical issues which mean that the measurement of the direct success or failure of microfinance is difficult. The current article provides a

theoretical foundation from which to analyse microfinance from a law and economics perspective.

This article has identified how the law can affect the average loan balance through an explicit cap on loan balance for microfinance loans, and this can have potential flow through effects to the profit margin, outreach to the poorest women, total outstanding loans, and subsequently on MFI size. Further, laws about how MFIs are able to collect loan repayments such as whether they are able to visit private residences, have the potential to influence portfolio at risk.³⁸⁵

This paper has identified the theoretical aspects of microfinance from a law and economics perspective. This means that the development of the financial market in which microfinance sits has been described with reference to how microfinance completes the market. From a theoretical perspective, economic development and increases to empowerment may be achieved as a result of access to credit and financial services, which in turn may be supported by microfinance. The sustainability of MFIs may promote microfinance through unrestricted outreach. Microfinance sustainability is directly affected by different forms of regulation. This paper has discussed some regulatory opportunities and the possible effects on the promotion of microfinance.

³⁸⁵ Portfolio at Risk (PAR) in the last 30 days.

List of Acronyms

Acronym	Meaning
MFI	Microfinance Institution
TML	Traditional Money Lender
ASIC	Australian Securities and Investments Commission
LVR	Loan to Valuation Ratio
SMM	Secondary Mortgage Market
LMI	Lenders Mortgage Insurance
PDS	Product Disclosure Statement
GDP	Gross Domestic Product
NGO	Non-Government Organisation
GFC	Global Financial Crisis
SHG	Self Help Group—savings and loan group
OSS	Operating Self Sufficiency—as defined by MIX market exchange
SME	Small and Medium sized Enterprise
RCT	Randomised Control Trials
CCT	Conditional Cash Transfer
TFP	Total Factor Productivity
PE	Partial Equilibrium
GE	General Equilibrium
ROE	Return on Equity
PAR	Portfolio At Risk in the last 30 days
DEA	Data Envelopment Analysis
MIX	Microfinance Information Exchange